Exhibit 14

CITY OF SAN DIEGO
MEMORANDUM

DATE: September 17, 2007

TO: Councilmember Donna Frye

FROM: Jay M.Goldstone, Chief Financial Officer / Interim Chief Operating Officer

SUBJECT: Response to Questions Regarding IRS Code Section 415

Attached you will find a response to the specific questions you raised regarding IRS Code Section 415. As you consider these responses, please note that many of the questions presented concern issues of tax law. My responses are based upon what I know at this point and to that extent I have provided my understanding of the various issues as they relate to the financial implications of this issue to the city. I am not an attorney, however, and would encourage you to further consult the Office of the City Attorney concerning matters involving interpretations of federal tax law.

1. **Please provide a copy of the relevant IRS Code Section(s) and an explanation for the intent of that those code Section(s).**

   I have attached a copy of IRS Code Section 415 ("Section 415") to this memorandum.

   My understanding of Section 415 is that it provides limits on benefits and contributions and other additions under qualified retirement plans. The purpose behind Section 415 is to limit the extent to which benefits and contributions can receive the favorable tax treatment provided to a qualified retirement plan.

2. **Please describe this "Compliance Strategy" in detail. Please specifically address the following questions in your description:**

   Copies of the "415(b), (c) and (n) Compliance Report Strategy Report" and the "415(m) Compliance Strategy Report" SDCERS filed with the IRS are attached to this memorandum.

   The first report discusses the limits imposed by Section 415 in great detail, including how those limits apply to SDCERS. The second report discusses Section 415(m) and the POB Plan establish by San Diego Municipal Code ("SDMC") Section 24.1603.

a. **It appears that this "Compliance Strategy" assumes the $22.8 million unfunded liability no longer exists as a SDCERS pension benefit and therefore removes it from the SDCERS financial and actuarial statements, but at the same time the City intends to continue to recognize it as a pension benefit and pay for it. Is that a correct description? If not, please explain why not?**

By adopting SDMC Section 24.1603, the City Council confirmed its intention to honor the City's pension obligations regardless of the 415 Dollar Limit. The City's POB Plan provides that the difference between the pension benefit that would otherwise be payable to a member but for the 415 Dollar Limit, and the pension benefit as capped under Section 415(b), will be paid from the POB Plan. Therefore, the City will pay pension benefits in excess of the 415 Dollar Limit from the POB Plan to SDCERS who will in turn provide this benefit to Retirees.

There is currently no clear accounting guidance on accounting for Qualified Excess Benefit Arrangements. To remediate this, we have contacted the Governmental Accounting Standards Board (GASB), and they have responded indicating that they may have no position on the matter. However, discussions with the GASB will continue.

It is the preliminary position of the City Comptroller that both SDCERS and the City should treat the Qualified Excess Benefit Arrangement (QEBA) as a defined benefit plan separate from the City and SDCERS qualified pension trust.

The Comptroller's accounting position involves the discrete reporting and separate valuation of the 415 plan by SDCERS actuary. If the City were to adopt this type of presentation, the result would be the accrual of a liability (NPO) on the City's financial statements for the difference between the Actuarially Required Contributions to the plan and the annual "pay as you go" expenses of the plan. When the plan is terminated, because no employees are exceeding the IRS limits, the NPO would be removed from the City's financial statements at such time the plan terminates because no retirees are violating the IRS limits.

b. **Currently the City and some of its employees are making pension contributions for future pension payments that apparently exceed IRS 415 legal limits. Those contributions are being invested in SDCERS which is a tax deferred 401(a) trust account. Does this IRS Compliance Strategy include the use of another tax deferred account?**

No. Code Section 415(b) limits the benefits payable from a qualified pension plan, not the contributions received by the plan.

As provided in SDMC Section 24.1606, and required by federal tax law, the POB Plan will be funded entirely by the City on an annual basis. No employee contribution or deferrals will be allowed into the POB Plan.

c. **Will this other account also be a 401(a) Trust?**

No. The POB is a 415(m) Trust.

d. **Are the contributions for pension benefits that exceed the IRS 415 limits going to be deposited into this other tax deferred account?**

No, this is not allowable under federal tax law or SDMC Section 24.1606.

e. **Has the IRS agreed that the City and its employees may continue to make contributions to pay for benefits that exceed the 415 limits by simply depositing those assets into this other tax deferred account thereby just shifting the assets and liability for the SDCERS pension account to this additional tax deferred account?**

No, this is not how the POB Plan operates. SDCERS 401(a) plan and the POB Plan are independently funded and contributions will never be transferred between the two. Pursuant to tax law and SDMC Section 24.1606(e), the City assets used to provide benefits under the POB Plan "may not be commingled with the monies of any other Plan in the Retirement System, or any other qualified plans, nor may this Plan ever receive any transfer of assets from the Trust Fund established for any other plan in the Retirement System."

f. **How many defined benefit employee pension plans may the City of San Diego legally have?**

There is no legal limit on the number of defined benefit plans the City can establish.

g. **Will we receive an Annual Actuarial Valuation for this additional pension plan? Who will prepare that valuation? Please provide the supporting actuarial schedule that forecasts the growth of this estimated $22.8 million unfunded liability and corresponding annual required contributions over the 20 year fixed amortization period using the EAN methodology and please**

disclose the other actuarial assumptions used in the schedule (i.e. 8% discount rate, 4.25% salary inflation, etc.).

Because the City will need to contribute the projected amount necessary and pay the pension benefits due from the POB Plan during that calendar year, no separate Annual Actuarial Valuation will be prepared for the POB Plan. That projected amount will be determined by SDCERS' actuary in accordance with procedures approved by the IRS.

h. Will SDCERS administer this plan?

Yes. When the City Council adopted SDMC Section 24.1605, it provided that "administration of the Plan shall be under the exclusive management and control of the [SDCERS] Board.

i. Will the annual required contribution to fund this $22.8 million unfunded liability be subject to GASB disclosure requirements? If so, which GASB Statements?

There is no GASB guidance specifically designed to address QEBA's. If this is determined to be a defined benefit plan, it will be reported accordingly and if it is not, then it will be reported as a defined contribution plan expense on the City's financial statements.

3. **Who made the decision to use this "Compliance Strategy"? Please provide any and all documentation relating to it.**

The City Council adopted Ordinance 0-18930 on March 19, 2001, establishing the POB Plan to pay promised pension benefits above the 415 Dollar Limit. This was the first step in implementing this compliance strategy.

4. **Has the IRS approved of this "Compliance Strategy"? If so, please provide documentation from the IRS that states they have approved this "Compliance Strategy."**

Congress created QEBAs for the purpose of paying benefits above the 415 Dollar Limit. The City Council chose to use this compliance option when it adopted the POB Plan.

SDCERS filed a private letter ruling request with the IRS with respect to the POB Plan, in order to ensure that it meets all of the statutory and regulatory requirements applicable to a QEBA. That request is pending.

5. **When did you first become aware of these IRS 415 violations?**

I personally was not aware of this issue until SDCERS issued its June 30, 2006 Actuarial Valuation in January 2007 and even then did not fully appreciate the issue until further discussions with SDCERS. It is my understanding that the current management of SDCERS first became aware of the IRC 415(b) violation in 2005. As a result, SDCERS filed a supplemental voluntary submission to the IRS in August 2006 which included issues relating to Code Section 415(b). However, it should be noted that the necessary changes to the municipal code to codify the QEBA were made in 2001, this suggests that members of past city management were aware of this issue.

6. **Did you make KPMG aware of this issue? If so, when?**

KPMG was provided all available documentation concerning the Voluntary Compliance Filing directly by SDCERS. The City Comptroller does recall reviewing the documentation with KPMG and discussing various issues related to the Voluntary Compliance filing during the December 2006 to February 2007 timeframe.

7. **Has this issue, the corresponding unfunded liability and annual required contributions been properly disclosed in the 2003 CAFR? If so, on what page?**

During the period reported in the 2003 CAFR and for previous periods, the QEBA plan was included in the City's Actuarial Liabilities for the City's 401A plan. This means that the $22.8 million was not excluded from the City's Annually Required Contribution and as such, the plan was fully expensed in the same manner as it would be under the City Comptroller's proposed accounting treatment. The result is that this has the same impact on the City's ending Net Assets for the period reported as if the QEBA was reported as a discrete defined benefit plan.

The City's financial statements were and still are, deemed to be reasonable and considered to be materially correct. Furthermore, the City's actuarially determined liabilities were correct in total. However, certain other disclosures required by GASB 27 were not included in the City's 2003 CAFR. These disclosures include discretely presenting the funding progress of the plan, the description of the plan and certain other actuarial information concerning the QEBA plan.

Considered from a quantitative perspective, the QEBA plan, valued as of June 30, 2006 constitutes .7% and .6% of fiduciary net assets held in trust by SDCERS and total Actuarial Accrued Liability respectively. Using 1% (which is considered low by most

professionals) as a basis for evaluating quantitative materiality to the financial statements, both indicators fall well below the acceptable range. As such, we are comfortable with the presentation of the 2003 CAFR.

It should be noted that staff has added a narrative discussion of the QEBA plan into the 2004 CAFR on page 105 of the CAFR.

8. **Has this issue, the corresponding unfunded liability and annual contributions been properly disclosed in the SDCERS 2003 and 2004 CAFRs?**

   The retrospective testing failures of benefits actually paid in excess of annual 415(b) limits were disclosed in SDCERS' fiscal year 2004 CAFR. It was not included in the SDCERS fiscal year 2003 CAFR. The impact to the City's Unfunded Actuarial Liability was disclosed in the City's June 30, 2006 Annual Actuarial Valuation. SDCERS has received an unqualified opinion on their 2004 CAFR.

9. **Who calculated the $22.8 million unfunded liability number? Have you confirmed that number with the City's actuary? If not, do you intend to?**

   SDCERS' actuary, Cheiron, calculated the impact of applying Section 415(b) limits to its calculations of the overall plan liabilities in the City's June 30, 2006 Annual Actuarial Valuation Report.

10. **Since this $22.8 million unfunded liability results from defined benefit pension promises that are outside the proper treatment of IRS 415 limitations how is it legal for the City of San Diego to simply assume that unfunded liability from SDCERS?**

    I will defer to the City Attorney for an answer to this question.

11. **Is this IRS 415 limit violation strictly created by the defined benefit pension payments or do the payments from the DROP accounts also contribute to the IRS 415 limit violation?**

    A member's DROP benefit must be included in the 415(b) limit testing, which increases the number of payees who exceed the 415(b) limits, as well as the amount by which they exceed the limits.

12. **How many employees are currently receiving pension benefits above what the IRS considers legal and/or are outside of benefit limitations? What is the average amount of benefits that are received per employee above the IRS limitations?**

After the IRS approves SDCERS' testing methodology, SDCERS will know the affected number of members and the exact amounts involved.

13. **Will this liability grow as more employees are added or have corrective actions been taken to prevent this from continuing? Is there any action(s) that the City Council should take to correct this?**

Whether any one individual's pension benefit will exceed the 415 Dollar Limit at retirement depends upon the actual Section 415(b) limits as set by Congress and adjusted by the IRS, and a variety of actuarial probabilities, such as how long the employee will work for the City, the probability of earning a vested benefit, the employee's age at retirement, the employee's pensionable compensation, how fast that compensation increases over the course of a career, the amount in the member's DROP account at retirement, and whether and how the benefit structure changes with respect to that employee.

The City Council took corrective action to eliminate Section 415(b) violations, while permitting payment of its promised benefits, by establishing the POB Plan.

14. **What is the dollar amount the City proposes to pay towards this unfunded liability in the 2008 budget? Where is the Annual Actuarial Valuation that supports that annual contribution amount?**

The City will not make any payment toward the "unfunded liability" for the excess benefits to be paid from the POB Plan. Instead, the City will pay into the POB Plan, on an annual basis, the amount necessary to pay that year's benefits above the 415 Dollar Limit. As explained above, the POB Plan cannot be pre-funded.

Each year SDCERS will determine the amount necessary to fund any pension benefits payable during that year in excess of the Section 415(b) limits. This amount will include the projected amount of all excess benefits payable for the calendar year to existing and projected payees, as well as the projected cost of administering the POB Plan.

SDCERS will provide information to the City and the City will fund this amount on an annual basis. Any amounts remaining in the POB Plan at the end of a calendar year will be carried forward to pay benefits and administrative costs in the following year.

15. **On what page of the proposed 2008 budget is that annual required contribution for this unfunded liability shown? (I believe that you referred me to page 133 of**

Volume II, but I cannot locate it.) Is the $22.8 million unfunded liability shown in the the budget or just the annual payment?

The projected payment to SDCERS for this liability has been budgeted in Citywide Program Expenditures and is on page 133 of Volume II of the proposed Fiscal Year 2008 Budget. It was not specifically called out in the budget document but rather is part of the $2,874,735.

With respect to the budget, we have budgeted payment of this liability on a pay as you go basis which is consistent with IRS requirements. As such, SDCERS has estimated the payment to be approximately $500,000. The City will ultimately pay the actual amount billed by SDCERS.

16. **Is there any other information of which you are aware that is material that I have not asked you?**

None that I can think of.

Attachments

Cc: Honorable Mayor Sanders
Honorable City Council Members
Honorable City Attorney
Independent Budget Analyst
SDCERS Administrator

U.S. Code collection

§ 415. Limitations on benefits and contribution under qualified plans

(a) General rule

(1) Trusts

A trust which is a part of a pension, profitsharing, or stock bonus plan shall not constitute a qualified trust under section 401 (a) if—

(A) in the case of a defined benefit plan, the plan provides for the payment of benefits with respect to a participant which exceed the limitation of subsection (b), or

(B) in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitation of subsection (c).

(2) Section applies to certain annuities and accounts

In the case of—

(A) an employee annuity plan described in section 403 (a),

(B) an annuity contract described in section 403 (b), or

(C) a simplified employee pension described in section 408 (k),

such a contract, plan, or pension shall not be considered to be described in section 403 (a), 403 (b), or 408 (k), as the case may be, unless it satisfies the requirements of subparagraph (A) or subparagraph (B) of paragraph (1), whichever is appropriate, and has not been disqualified under subsection (g). In the case of an annuity contract described in section 403 (b), the preceding sentence shall apply only to the portion of the annuity contract which exceeds the limitation of subsection (b) or the limitation of subsection (c), whichever is appropriate.

(b) Limitation for defined benefit plans

(1) In general

Benefits with respect to a participant exceed the limitation of this subsection if, when expressed as an annual benefit (within the meaning of paragraph (2)), such annual benefit is greater than the lesser of—

(A) $160,000, or

(B) 100 percent of the participant's average compensation for his high 3

years.

(2) Annual benefit

(A) In general

For purposes of paragraph (1), the term "annual benefit" means a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions (as defined in sections 402 (c), 403 (a)(4), 403 (b)(8), 408 (d)(3), and 457 (e)(16)) are made.

(B) Adjustment for certain other forms of benefit

If the benefit under the plan is payable in any form other than the form described in subparagraph (A), or if the employees contribute to the plan or make rollover contributions (as defined in sections 402 (c), 403 (a)(4), 403 (b)(8), 408 (d)(3), and 457 (e)(16)), the determinations as to whether the limitation described in paragraph (1) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary by adjusting such benefit so that it is equivalent to the benefit described in subparagraph (A). For purposes of this subparagraph, any ancillary benefit which is not directly related to retirement income benefits shall not be taken into account; and that portion of any joint and survivor annuity which constitutes a qualified joint and survivor annuity (as defined in section 417) shall not be taken into account.

(C) Adjustment to $160,000 limit where benefit begins before age 62

If the retirement income benefit under the plan begins before age 62, the determination as to whether the $160,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by reducing the limitation of paragraph (1)(A) so that such limitation (as so reduced) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $160,000 annual benefit beginning at age 62.

(D) Adjustment to $160,000 limit where benefit begins after age 65

If the retirement income benefit under the plan begins after age 65, the determination as to whether the $160,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by increasing the limitation of paragraph (1)(A) so that such limitation (as so increased) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $160,000 annual benefit beginning at age 65.

(E) Limitation on certain assumptions

(i) For purposes of adjusting any limitation under subparagraph (C) and, except as provided in clause (ii), for purposes of adjusting any benefit under subparagraph (B), the interest rate assumption shall not be less than the greater of 5 percent or the rate specified in the plan.

(ii) For purposes of adjusting any benefit under subparagraph (B) for any form of benefit subject to section 417 (e)(3), the applicable interest rate (as defined in section 417 (e)(3)) shall be substituted for "5 percent" in clause (i), except that in the case of plan years beginning in 2004 or 2005, "5.5 percent" shall be substituted for "5

percent" in clause (i).

(iii) For purposes of adjusting any limitation under subparagraph (D), the interest rate assumption shall not be greater than the lesser of 5 percent or the rate specified in the plan.

(iv) For purposes of this subsection, no adjustments under subsection (d)(1) shall be taken into account before the year for which such adjustment first takes effect.

(v) For purposes of adjusting any benefit or limitation under subparagraph (B), (C), or (D), the mortality table used shall be the table prescribed by the Secretary. Such table shall be based on the prevailing commissioners' standard table (described in section 807 (d)(5)(A)) used to determine reserves for group annuity contracts issued on the date the adjustment is being made (without regard to any other subparagraph of section 807 (d)(5)).

[(F) Repealed. Pub. L. 107–16, title VI, § 611(a)(5)(A), June 7, 2001, 115 Stat. 97]

(G) Special limitation for qualified police or firefighters

In the case of a qualified participant, subparagraph (C) of this paragraph shall not apply.

(H) Qualified participant defined

For purposes of subparagraph (G), the term "qualified participant" means a participant—

(i) in a defined benefit plan which is maintained by a State or political subdivision thereof,

(ii) with respect to whom the period of service taken into account in determining the amount of the benefit under such defined benefit plan includes at least 15 years of service of the participant—

(I) as a full-time employee of any police department or fire department which is organized and operated by the State or political subdivision maintaining such defined benefit plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision, or

(II) as a member of the Armed Forces of the United States.

(I) Exemption for survivor and disability benefits provided under governmental plans

Subparagraph (C) of this paragraph and paragraph (5) shall not apply to—

(i) income received from a governmental plan (as defined in section 414 (d)) as a pension, annuity, or similar allowance as the result of the recipient becoming disabled by reason of personal injuries or sickness, or

(ii) amounts received from a governmental plan by the beneficiaries, survivors, or the estate of an employee as the result of the death of the employee.

(3) Average compensation for high 3 years

For purposes of paragraph (1), a participant's high 3 years shall be the period of consecutive calendar years (not more than 3) during which the participant both was an active participant in the plan and had the greatest aggregate compensation from the employer. In the case of an employee within the meaning of section 401 (c)(1), the preceding sentence shall be applied by substituting for "compensation from the employer" the following: "the participant's earned income (within the meaning of section 401 (c)(2) but determined without regard to any exclusion under section 911)".

(4) Total annual benefits not in excess of $10,000

Notwithstanding the preceding provisions of this subsection, the benefits payable with respect to a participant under any defined benefit plan shall be deemed not to exceed the limitation of this subsection if—

(A) the retirement benefits payable with respect to such participant under such plan and under all other defined benefit plans of the employer do not exceed $10,000 for the plan year, or for any prior plan year, and

(B) the employer has not at any time maintained a defined contribution plan in which the participant participated.

(5) Reduction for participation or service of less than 10 years

(A) Dollar limitation

In the case of an employee who has less than 10 years of participation in a defined benefit plan, the limitation referred to in paragraph (1)(A) shall be the limitation determined under such paragraph (without regard to this paragraph) multiplied by a fraction—

(i) the numerator of which is the number of years (or part thereof) of participation in the defined benefit plan of the employer, and

(ii) the denominator of which is 10.

(B) Compensation and benefits limitations

The provisions of subparagraph (A) shall apply to the limitations under paragraphs (1)(B) and (4), except that such subparagraph shall be applied with respect to years of service with an employer rather than years of participation in a plan.

(C) Limitation on reduction

In no event shall subparagraph (A) or (B) reduce the limitations referred to in paragraphs (1) and (4) to an amount less than 1/10 of such limitation (determined without regard to this paragraph).

(D) Application to changes in benefit structure

To the extent provided in regulations, subparagraph (A) shall be applied separately with respect to each change in the benefit structure of a plan.

(6) Computation of benefits and contributions

The computation of—

(A) benefits under a defined contribution plan, for purposes of section 401

(a)(4),

(B) contributions made on behalf of a participant in a defined benefit plan, for purposes of section 401 (a)(4), and

(C) contributions and benefits provided for a participant in a plan described in section 414 (k), for purposes of this section

shall not be made on a basis inconsistent with regulations prescribed by the Secretary.

(7) Benefits under certain collectively bargained plans

For a year, the limitation referred to in paragraph (1)(B) shall not apply to benefits with respect to a participant under a defined benefit plan (other than a multiemployer plan)—

(A) which is maintained for such year pursuant to a collective bargaining agreement between employee representatives and one or more employers,

(B) which, at all times during such year, has at least 100 participants,

(C) under which benefits are determined solely by reference to length of service, the particular years during which service was rendered, age at retirement, and date of retirement,

(D) which provides that an employee who has at least 4 years of service has a nonforfeitable right to 100 percent of his accrued benefit derived from employer contributions, and

(E) which requires, as a condition of participation in the plan, that an employee complete a period of not more than 60 consecutive days of service with the employer or employers maintaining the plan.

This paragraph shall not apply to a participant whose compensation for any 3 years during the 10-year period immediately preceding the year in which he separates from service exceeded the average compensation for such 3 years of all participants in such plan. This paragraph shall not apply to a participant for any period for which he is a participant under another plan to which this section applies which is maintained by an employer maintaining this plan. For any year for which the paragraph applies to benefits with respect to a participant, paragraph (1)(A) and subsection (d)(1)(A) shall be applied with respect to such participant by substituting one-half the amount otherwise applicable for such year under paragraph (1)(A) for "$160,000".

(8) Social security retirement age defined

For purposes of this subsection, the term "social security retirement age" means the age used as the retirement age under section 216(l) of the Social Security Act, except that such section shall be applied—

(A) without regard to the age increase factor, and

(B) as if the early retirement age under section 216(l)(2) of such Act were 62.

(9) Special rule for commercial airline pilots

(A) In general

Except as provided in subparagraph (B), in the case of any participant who is a commercial airline pilot, if, as of the time of the participant's

retirement, regulations prescribed by the Federal Aviation Administration require an individual to separate from service as a commercial airline pilot after attaining any age occurring on or after age 60 and before age 62, paragraph (2)(C) shall be applied by substituting such age for age 62.

(B) Individuals who separate from service before age 60

If a participant described in subparagraph (A) separates from service before age 60, the rules of paragraph (2)(C) shall apply.

(10) Special rule for State and local government plans

(A) Limitation to equal accrued benefit

In the case of a plan maintained for its employees by any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, the limitation with respect to a qualified participant under this subsection shall not be less than the accrued benefit of the participant under the plan (determined without regard to any amendment of the plan made after October 14, 1987).

(B) Qualified participant

For purposes of this paragraph, the term "qualified participant" means a participant who first became a participant in the plan maintained by the employer before January 1, 1990.

(C) Election

(i) In general This paragraph shall not apply to any plan unless each employer maintaining the plan elects before the close of the 1st plan year beginning after December 31, 1989, to have this subsection (other than paragraph (2)(G)).

(ii) Revocation of election An election under clause (i) may be revoked not later than the last day of the third plan year beginning after the date of the enactment of this clause. The revocation shall apply to all plan years to which the election applied and to all subsequent plan years. Any amount paid by a plan in a taxable year ending after the revocation shall be includible in income in such taxable year under the rules of this chapter in effect for such taxable year, except that, for purposes of applying the limitations imposed by this section, any portion of such amount which is attributable to any taxable year during which the election was in effect shall be treated as received in such taxable year.

(11) Special limitation rule for governmental and multiemployer plans

In the case of a governmental plan (as defined in section 414 (d)) or a multiemployer plan (as defined in section 414 (f)), subparagraph (B) of paragraph (1) shall not apply.

(c) Limitation for defined contribution plans

(1) In general

Contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an annual addition (within the meaning of paragraph (2)) to the participant's account, such annual

addition is greater than the lesser of—

(A) $40,000, or

(B) 100 percent of the participant's compensation.

(2) Annual addition

For purposes of paragraph (1), the term "annual addition" means the sum of any year of—

(A) employer contributions,

(B) the employee contributions, and

(C) forfeitures.

For the purposes of this paragraph, employee contributions under subparagraph (B) are determined without regard to any rollover contributions (as defined in sections 402 (c), 403 (a)(4), 403 (b)(8), 408 (d)(3), and 457 (e)(16)) without regard to employee contributions to a simplified employee pension which are excludable from gross income under section 408 (k)(6). Subparagraph (B) of paragraph (1) shall not apply to any contribution for medical benefits (within the meaning of section 419A (f)(2)) after separation from service which is treated as an annual addition.

(3) Participant's compensation

For purposes of paragraph (1)—

(A) In general

The term "participant's compensation" means the compensation of the participant from the employer for the year.

(B) Special rule for self-employed individuals

In the case of an employee within the meaning of section 401 (c)(1), subparagraph (A) shall be applied by substituting "the participant's earned income (within the meaning of section 401 (c)(2) but determined without regard to any exclusion under section 911)" for "compensation of the participant from the employer".

(C) Special rules for permanent and total disability

In the case of a participant in any defined contribution plan—

(i) who is permanently and totally disabled (as defined in section 22 (e)(3)),

(ii) who is not a highly compensated employee (within the meaning of section 414 (q)), and

(iii) with respect to whom the employer elects, at such time and in such manner as the Secretary may prescribe, to have this subparagraph apply,

the term "participant's compensation" means the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally disabled. This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this

subparagraph are nonforfeitable when made. If a defined contribution plan provides for the continuation of contributions on behalf of all participants described in clause (i) for a fixed or determinable period, this subparagraph shall be applied without regard to clauses (ii) and (iii).

(D) Certain deferrals included

The term "participant's compensation" shall include—

(i) any elective deferral (as defined in section 402 (g)(3)), and

(ii) any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of section 125, 132 (f)(4), or 457.

(E) Annuity contracts

In the case of an annuity contract described in section 403 (b), the term "participant's compensation" means the participant's includible compensation determined under section 403 (b)(3).

[(4) Repealed. Pub. L. 107–16, title VI, § 632(a)(3)(E), June 7, 2001, 115 Stat. 114]

[(5) Repealed. Pub. L. 97–248, title II, § 238(d)(5), Sept. 3, 1982, 96 Stat. 513]

(6) Special rule for employee stock ownership plans

If no more than one-third of the employer contributions to an employee stock ownership plan (as described in section 4975 (e)(7)) for a year which are deductible under paragraph (9) of section 404 (a) are allocated to highly compensated employees (within the meaning of section 414 (q)), the limitations imposed by this section shall not apply to—

(A) forfeitures of employer securities (within the meaning of section 409) under such an employee stock ownership plan if such securities were acquired with the proceeds of a loan (as described in section 404 (a)(9)(A)), or

(B) employer contributions to such an employee stock ownership plan which are deductible under section 404 (a)(9)(B) and charged against the participant's account.

The amount of any qualified gratuitous transfer (as defined in section 664 (g)(1)) allocated to a participant for any limitation year shall not exceed the limitations imposed by this section, but such amount shall not be taken into account in determining whether any other amount exceeds the limitations imposed by this section.

(7) Special rules relating to church plans

(A) Alternative contribution limitation

(i) In general Notwithstanding any other provision of this subsection, at the election of a participant who is an employee of a church or a convention or association of churches, including an organization described in section 414 (e)(3)(B)(ii), contributions and other additions for an annuity contract or retirement income account described in section 403 (b) with respect to such participant, when expressed as an annual addition to such participant's account, shall be

treated as not exceeding the limitation of paragraph (1) if such annual addition is not in excess of $10,000.

(ii) $40,000 aggregate limitation The total amount of additions with respect to any participant which may be taken into account for purposes of this subparagraph for all years may not exceed $40,000.

(B) Number of years of service for duly ordained, commissioned, or licensed ministers or lay employees

For purposes of this paragraph—

(i) all years of service by—

(I) a duly ordained, commissioned, or licensed minister of a church, or

(II) a lay person,

as an employee of a church, a convention or association of churches, including an organization described in section 414 (e)(3)(B)(ii), shall be considered as years of service for 1 employer, and

(ii) all amounts contributed for annuity contracts by each such church (or convention or association of churches) or such organization during such years for such minister or lay person shall be considered to have been contributed by 1 employer.

(C) Foreign missionaries

In the case of any individual described in subparagraph (B) performing services outside the United States, contributions and other additions for an annuity contract or retirement income account described in section 403 (b) with respect to such employee, when expressed as an annual addition to such employee's account, shall not be treated as exceeding the limitation of paragraph (1) if such annual addition is not in excess of $3,000. This subparagraph shall not apply with respect to any taxable year to any individual whose adjusted gross income for such taxable year (determined separately and without regard to community property laws) exceeds $17,000.

(D) Annual addition

For purposes of this paragraph, the term "annual addition" has the meaning given such term by paragraph (2).

(E) Church, convention or association of churches

For purposes of this paragraph, the terms "church" and "convention or association of churches" have the same meaning as when used in section 414 (e).

(d) Cost-of-living adjustments

(1) In general

The Secretary shall adjust annually—

(A) the $160,000 amount in subsection (b)(1)(A),

(B) in the case of a participant who is separated from service, the amount

taken into account under subsection (b)(1)(B), and

(C) the $40,000 amount in subsection (c)(1)(A),

for increases in the cost-of-living in accordance with regulations prescribed by the Secretary.

(2) Method

The regulations prescribed under paragraph (1) shall provide for—

(A) an adjustment with respect to any calendar year based on the increase in the applicable index for the calendar quarter ending September 30 of the preceding calendar year over such index for the base period, and

(B) adjustment procedures which are similar to the procedures used to adjust benefit amounts under section 215(i)(2)(A) of the Social Security Act.

(3) Base period

For purposes of paragraph (2)—

(A) $160,000 amount

The base period taken into account for purposes of paragraph (1)(A) is the calendar quarter beginning July 1, 2001.

(B) Separations after December 31, 1994

The base period taken into account for purposes of paragraph (1)(B) with respect to individuals separating from service with the employer after December 31, 1994, is the calendar quarter beginning July 1 of the calendar year preceding the calendar year in which such separation occurs.

(C) Separations before January 1, 1995

The base period taken into account for purposes of paragraph (1)(B) with respect to individuals separating from service with the employer before January 1, 1995, is the calendar quarter beginning October 1 of the calendar year preceding the calendar year in which such separation occurs.

(D) $40,000 amount

The base period taken into account for purposes of paragraph (1)(C) is the calendar quarter beginning July 1, 2001.

(4) Rounding

(A) $160,000 amount

Any increase under subparagraph (A) of paragraph (1) which is not a multiple of $5,000 shall be rounded to the next lowest multiple of $5,000. This subparagraph shall also apply for purposes of any provision of this title that provides for adjustments in accordance with the method contained in this subsection, except to the extent provided in such provision.

(B) $40,000 amount

Any increase under subparagraph (C) of paragraph (1) which is not a

multiple of $1,000 shall be rounded to the next lowest multiple of $1,000.

[(e) Repealed. Pub. L. 104–188, title I, § 1452(a), Aug. 20, 1996, 110 Stat. 1816]

(f) Combining of plans

(1) In general

For purposes of applying the limitations of subsections (b) and (c)—

(A) all defined benefit plans (whether or not terminated) of an employer are to be treated as one defined benefit plan, and

(B) all defined contribution plans (whether or not terminated) of an employer are to be treated as one defined contribution plan.

(2) Annual compensation taken into account for defined benefit plans

If the employer has more than one defined benefit plan—

(A) subsection (b)(1)(B) shall be applied separately with respect to each such plan, but

(B) in applying subsection (b)(1)(B) to the aggregate of such defined benefit plans for purposes of this subsection, the high 3 years of compensation taken into account shall be the period of consecutive calendar years (not more than 3) during which the individual had the greatest aggregate compensation from the employer.

(3) Exception for multiemployer plans

Notwithstanding paragraph (1) and subsection (g), a multiemployer plan (as defined in section 414 (f)) shall not be combined or aggregated—

(A) with any other plan which is not a multiemployer plan for purposes of applying subsection (b)(1)(B) to such other plan, or

(B) with any other multiemployer plan for purposes of applying the limitations established in this section.

(g) Aggregation of plans

Except as provided in subsection (f)(3), the Secretary, in applying the provisions of this section to benefits or contributions under more than one plan maintained by the same employer, and to any trusts, contracts, accounts, or bonds referred to in subsection (a)(2), with respect to which the participant has the control required under section 414 (b) or (c), as modified by subsection (h), shall, under regulations prescribed by the Secretary, disqualify one or more trusts, plans, contracts, accounts, or bonds, or any combination thereof until such benefits or contributions do not exceed the limitations contained in this section. In addition to taking into account such other factors as may be necessary to carry out the purposes of subsection (f), the regulations prescribed under this paragraph shall provide that no plan which has been terminated shall be disqualified until all other trusts, plans, contracts, accounts, or bonds have been disqualified.

(h) 50 percent control

For purposes of applying subsections (b) and (c) of section 414 to this section, the phrase "more than 50 percent" shall be substituted for the phrase "at least 80

percent" each place it appears in section 1563 (a)(1).

(i) Records not available for past periods

Where for the period before January 1, 1976, or (if later) the first day of the first plan year of the plan, the records necessary for the application of this section are not available, the Secretary may by regulations prescribe alternate methods for determining the amounts to be taken into account for such period.

(j) Regulations; definition of year

The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including, but not limited to, regulations defining the term "year" for purposes of any provision of this section.

(k) Special rules

(1) Defined benefit plan and defined contribution plan

For purposes of this title, the term "defined contribution plan" or "defined benefit plan" means a defined contribution plan (within the meaning of section 414 (i)) or a defined benefit plan (within the meaning of section 414 (j)), whichever applies, which is—

(A) a plan described in section 401 (a) which includes a trust which is exempt from tax under section 501 (a),

(B) an annuity plan described in section 403 (a),

(C) an annuity contract described in section 403 (b), or

(D) a simplified employee pension.

(2) Contributions to provide cost-of-living protection under defined benefit plans

(A) In general

In the case of a defined benefit plan which maintains a qualified cost-of-living arrangement—

(i) any contribution made directly by an employee under such an arrangement shall not be treated as an annual addition for purposes of subsection (c), and

(ii) any benefit under such arrangement which is allocable to an employer contribution which was transferred from a defined contribution plan and to which the requirements of subsection (c) were applied shall, for purposes of subsection (b), be treated as a benefit derived from an employee contribution (and subsection (c) shall not again apply to such contribution by reason of such transfer).

(B) Qualified cost-of-living arrangement defined

For purposes of this paragraph, the term "qualified cost-of-living arrangement" means an arrangement under a defined benefit plan which—

(i) provides a cost-of-living adjustment to a benefit provided under such plan or a separate plan subject to the requirements of section 412, and

(ii) meets the requirements of subparagraphs (C), (D), (E), and (F) and such other requirements as the Secretary may prescribe.

(C) Determination of amount of benefit

An arrangement meets the requirement of this subparagraph only if the cost-of-living adjustment of participants is based—

(i) on increases in the cost-of-living after the annuity starting date, and

(ii) on average cost-of-living increases determined by reference to 1 or more indexes prescribed by the Secretary, except that the arrangement may provide that the increase for any year will not be less than 3 percent of the retirement benefit (determined without regard to such increase).

(D) Arrangement elective; time for election

An arrangement meets the requirements of this subparagraph only if it is elective, it is available under the same terms to all participants, and it provides that such election may at least be made in the year in which the participant—

(i) attains the earliest retirement age under the defined benefit plan (determined without regard to any requirement of separation from service), or

(ii) separates from service.

(E) Nondiscrimination requirements

An arrangement shall not meet the requirements of this subparagraph if the Secretary finds that a pattern of discrimination exists with respect to participation.

(F) Special rules for key employees

(i) In general An arrangement shall not meet the requirements of this paragraph if any key employee is eligible to participate.

(ii) Key employee For purposes of this subparagraph, the term "key employee" has the meaning given such term by section 416 (i)(1), except that in the case of a plan other than a top-heavy plan (within the meaning of section 416 (g)), such term shall not include an individual who is a key employee solely by reason of section 416 (i)(1)(A)(i).

(3) Repayments of cashouts under governmental plans

In the case of any repayment of contributions (including interest thereon) to the governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan or under another governmental plan maintained by a State or local government employer within the same State, any such repayment shall not be taken into account for purposes of this section.

(4) Special rules for sections 403 (b) and 408

For purposes of this section, any annuity contract described in section 403 (b) for the benefit of a participant shall be treated as a defined contribution plan maintained by each employer with respect to which the participant has the

control required under subsection (b) or (c) of section 414 (as modified by subsection (h)). For purposes of this section, any contribution by an employer to a simplified employee pension plan for an individual for a taxable year shall be treated as an employer contribution to a defined contribution plan for such individual for such year.

(l) Treatment of certain medical benefits

(1) In general

For purposes of this section, contributions allocated to any individual medical benefit account which is part of a pension or annuity plan shall be treated as an annual addition to a defined contribution plan for purposes of subsection (c). Subparagraph (B) of subsection (c)(1) shall not apply to any amount treated as an annual addition under the preceding sentence.

(2) Individual medical benefit account

For purposes of paragraph (1), the term "individual medical benefit account" means any separate account—

(A) which is established for a participant under a pension or annuity plan, and

(B) from which benefits described in section 401 (h) are payable solely to such participant, his spouse, or his dependents.

(m) Treatment of qualified governmental excess benefit arrangements

(1) Governmental plan not affected

In determining whether a governmental plan (as defined in section 414 (d)) meets the requirements of this section, benefits provided under a qualified governmental excess benefit arrangement shall not be taken into account. Income accruing to a governmental plan (or to a trust that is maintained solely for the purpose of providing benefits under a qualified governmental excess benefit arrangement) in respect of a qualified governmental excess benefit arrangement shall constitute income derived from the exercise of an essential governmental function upon which such governmental plan (or trust) shall be exempt from tax under section 115.

(2) Taxation of participant

For purposes of this chapter—

(A) the taxable year or years for which amounts in respect of a qualified governmental excess benefit arrangement are includible in gross income by a participant, and

(B) the treatment of such amounts when so includible by the participant,

shall be determined as if such qualified governmental excess benefit arrangement were treated as a plan for the deferral of compensation which is maintained by a corporation not exempt from tax under this chapter and which does not meet the requirements for qualification under section 401.

(3) Qualified governmental excess benefit arrangement

For purposes of this subsection, the term "qualified governmental excess benefit arrangement" means a portion of a governmental plan if—

(A) such portion is maintained solely for the purpose of providing to participants in the plan that part of the participant's annual benefit otherwise payable under the terms of the plan that exceeds the limitations on benefits imposed by this section,

(B) under such portion no election is provided at any time to the participant (directly or indirectly) to defer compensation, and

(C) benefits described in subparagraph (A) are not paid from a trust forming a part of such governmental plan unless such trust is maintained solely for the purpose of providing such benefits.

(n) Special rules relating to purchase of permissive service credit

(1) In general

If an employee makes 1 or more contributions to a defined benefit governmental plan (within the meaning of section 414 (d)) to purchase permissive service credit under such plan, then the requirements of this section shall be treated as met only if—

(A) the requirements of subsection (b) are met, determined by treating the accrued benefit derived from all such contributions as an annual benefit for purposes of subsection (b), or

(B) the requirements of subsection (c) are met, determined by treating all such contributions as annual additions for purposes of subsection (c).

(2) Application of limit

For purposes of—

(A) applying paragraph (1)(A), the plan shall not fail to meet the reduced limit under subsection (b)(2)(C) solely by reason of this subsection, and

(B) applying paragraph (1)(B), the plan shall not fail to meet the percentage limitation under subsection (c)(1)(B) solely by reason of this subsection.

(3) Permissive service credit

For purposes of this subsection—

(A) In general

The term "permissive service credit" means service credit—

(i) recognized by the governmental plan for purposes of calculating a participant's benefit under the plan,

(ii) which such participant has not received under such governmental plan, and

(iii) which such participant may receive only by making a voluntary additional contribution, in an amount determined under such governmental plan, which does not exceed the amount necessary to fund the benefit attributable to such service credit.

(B) Limitation on nonqualified service credit

A plan shall fail to meet the requirements of this section if—

(i) more than 5 years of permissive service credit attributable to nonqualified service are taken into account for purposes of this subsection, or

(ii) any permissive service credit attributable to nonqualified service is taken into account under this subsection before the employee has at least 5 years of participation under the plan.

(C) Nonqualified service

For purposes of subparagraph (B), the term "nonqualified service" means service for which permissive service credit is allowed other than—

(i) service (including parental, medical, sabbatical, and similar leave) as an employee of the Government of the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing (other than military service or service for credit which was obtained as a result of a repayment described in subsection (k)(3)),

(ii) service (including parental, medical, sabbatical, and similar leave) as an employee (other than as an employee described in clause (i)) of an educational organization described in section 170 (b)(1)(A)(ii) which is a public, private, or sectarian school which provides elementary or secondary education (through grade 12), as determined under State law,

(iii) service as an employee of an association of employees who are described in clause (i), or

(iv) military service (other than qualified military service under section 414 (u)) recognized by such governmental plan.

In the case of service described in clause (i), (ii), or (iii), such service will be nonqualified service if recognition of such service would cause a participant to receive a retirement benefit for the same service under more than one plan.

EXHIBIT 2

SAN DIEGO CITY EMPLOYEES RETIREMENT SYSTEM

415(b), (c), and (n) Compliance Strategy Report

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TABLE OF CONTENTS

I.
INTRODUCTION

Ice Miller LLP ("Ice Miller") has been retained to provide a compliance review with regard to the Internal Revenue Code of 1986, as amended ("Code"), requirements applicable to the status of the San Diego City Employees' Retirement System ("SDCERS") as a qualified retirement plan under Code Section 401(a).

Ice Miller is not considering tax reporting and withholding under the Code nor any other federal law. We are also not deliberating any state law issues. Where state law must be considered, we are relying on interpretations provided by SDCERS counsel.

This report pertains to Code Section 415(b) and 415(c), and to Code Section 415(n) as it is related to 415(b) and 415(c). We have touched on Code Section 415(m) only with respect to the treatment of excess benefits under Code Section 415(b). We have prepared a separate briefing document for SDCERS on the topic of 415(m).

We have based this report on the material provided to us by SDCERS. We have not independently verified what has been provided to us. We are relying on SDCERS to provide us with documents, forms, and information necessary for this review.

II.
IMPORTANCE OF CODE SECTION 415 COMPLIANCE

A. SDCERS AS A QUALIFIED GOVERNMENTAL PLAN

Retaining "qualified plan" status under Code Section 401(a) is an important requirement for retirement plans. The primary advantages in retaining "qualified" status are that (i) employer contributions are not taxable to members as they are made (even when vested) and taxation only occurs when plan distributions are made, (ii) earnings and income are not taxed to the trust or the members; (iii) certain favorable tax treatments are available to members when they receive plan distributions, e.g., ability to rollover amounts; (iv) employers may "pick up" employee contributions; and (v) employer contributions to, and benefits from, the plan are never subject to employment taxes (i.e., FICA taxes). These advantages would generally not apply to a non-qualified plan.

B. CODE SECTION 415 LIMITS

One key qualification requirement applicable to qualified plans is the Code Section 415 limits. Code Section 415 benefit and contribution limits must be followed to protect the tax qualified status of a retirement plan under Code Section 401(a). These limits must be met by all plan members. If even one member is paid an annual benefit greater than Code Section 415 allows, or contributes more than Code Section 415 allows, theoretically, the entire plan will be disqualified.

C. PROPOSED REGULATIONS

On May 31, 2005, the IRS issued proposed regulations for Code Section 415 (the "Proposed Regulations"). The Proposed Regulations are mentioned below where their provisions are of particular interest or concern. However, given that it is expected that the IRS will finalize these regulations in 2006, and we anticipate some changes being made to the regulations as they move to final, we have not included an in-depth analysis of the Proposed Regulations in this overview. However, we have attached a summary of key areas addressed by the Proposed Regulations as Appendix A. Recently, the IRS issued Notice 2005-87, which states that the grandfather provisions contained in the Proposed Regulations will be expanded upon issuance of final regulations.

III.
OVERVIEW OF LAW WITH RESPECT TO DEFINED BENEFIT LIMITATIONS

This Section of our Compliance Strategy Report provides an overview of the federal law with regard to Code Section 415(b). The impact of Code Section 415(b) on SDCERS and our specific recommendations for a compliance strategy are included in the next Section of this Report.

A. BASIC BENEFIT LIMITS

1. Current Limits

As amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the basic requirement of Code Section 415(b) is that the annual benefit in the form of a single life annuity provided to a member who is between the ages of 62 and 65 may not exceed the lesser of: (1) $160,000 as adjusted for inflation in $5,000 increments (the "Dollar Limit"), or (2) 100% of average compensation (the "Salary Limit"). Code Section 415(b)(1). For the 2006 calendar limitation year, the Dollar Limit is $175,000. The Salary Limit does not apply to governmental plans such as SDCERS. Therefore, the following discussion and our methodology do not include the Salary Limit.

The Proposed Regulations would require that limits be applied on an annual basis to the accrued benefit. In Ice Miller's comment letter to the IRS with regard to the Proposed Regulations, we stated the following on this point:

> We do have one overarching concern with the Proposed Regulations. They are fundamentally based on an annual accrual concept. For private sector plans this works well and is entirely consistent with the requirements and structure of Code Sections 411 and 412. However, these rules are not applicable to governmental plans, and, for most governmental plans, this concept does not work. In the governmental environment, vesting is generally determined by state law or local ordinances. In many cases, there is no "accrual" concept in the governing laws, but rather set benefits payable at certain events.

Therefore, we have prepared this compliance strategy report on the assumption that benefit testing for 415(b) purposes will be done at benefit payout.

2. Limitation Year

The annual benefit is tested in a "limitation year." Unless an election is made by the employer, the limitation year is the calendar year. Treas. Reg. § 1.415-2(b)(1). An employer that maintains more than one qualified plan may elect to use different limitation years for each such plan. Treas. Reg. § 1.415-2(b)(3).

B. TAMRA Election

Section 415(b)(10) of the Code was added by the Technical and Miscellaneous Revenue Act of 1988 (sometimes called TAMRA) to offer state and local government plans a means of complying with the Section 415 limits without violating state anti-cutback laws. Under this Section, the defined benefit limit for an employee who became a participant in the plan before January 1, 1990, would not be less than his or her accrued benefit determined without regard to any plan amendment adopted after October 14, 1987. However, for a state or local government to take advantage of Section 415(b)(10), each employer maintaining the plan was required to elect, before the close of the plan year beginning in 1990, to apply the defined benefit limits applicable to private plans to employees who first became participants after 1990. However, there were also special provisions for state-wide statutory changes. For plans that made a TAMRA election, the qualified participants would still have their TAMRA protection.

C. Amounts Excluded from Testing

For purposes of Code Section 415(b), the annual benefit means the benefit payable annually in the form of a straight life annuity (with no ancillary benefits), without considering payments made from a qualified excess benefit arrangement, after-tax employee contributions, and any rollover contributions. Code Section 415(b)(2).

1. Ancillary Benefits

"Ancillary benefits" do not count toward the benefits subject to Code Section 415. As a result, any benefit that is an ancillary benefit can exceed the 415 limits without the plan being disqualified. Generally, "ancillary benefits" are benefits not directly related to retirement income benefits. Ancillary benefits include "pre-retirement disability benefits and death benefits (such as in-service death benefits)." Code Section 415(b)(2)(B); Treas. Reg. § 1.415-3(c)(ii).

a. Pre-Retirement Disability Benefits

According to a non-precedential IRS Information Letter (IRS Information Letter on § 415 Limitations on Public Plans dated August 20, 1991 ("IRS Letter")) discussing Code Section 415 limitations on governmental plans, pre-retirement disability benefits under governmental plans are not taken into account under Code Section 415, even if the pre-retirement disability benefits exceed the "qualified disability benefit" limitations established in Code Section 411(a)(9). IRS Letter, § 1 Q&A-3; Treas. Reg. § 1.415-3(c)(ii). However, pre-retirement disability benefits are required to comply with Revenue Ruling 72-3, which prohibits a pension plan benefit from

exceeding 100% of the employee's compensation. For this purpose, the definition of the term "compensation" is similar to the definition identified in Code Section 415 and is subject to cost of living increases. Thus, there is still a test that needs to apply to pre-retirement disability benefits. Contrasted to pre-retirement disability benefits, post-retirement disability benefits must be taken into account for purposes of complying with the Code Section 415 limitations. IRS Letter, § 1 Q&A-4. Thus, (1) post-retirement disability benefits, (2) line of duty disability benefits paid post normal retirement date, and (3) pre-retirement disability benefits payable post normal retirement age will be tested under Code Section 415(b).

b. Pre-Retirement Death Benefits

Pre-retirement death benefits provided under a governmental plan are also exempt from the Code Section 415 limits. IRS Letter, § 1 Q&A-5; Treas. Reg. § 1.415-3(c)(ii). However, pre-retirement death benefits must meet the incidental benefit requirements of Code Section 401 and the regulations thereto. Generally speaking, death benefits are incidental where the plan provides a pre-retirement death benefit that is no greater than 100 times the monthly annuity benefit provided under the plan, or the cost of the death benefit does not exceed 25% of the total cost of all benefits for that participant. (This latter test would be one that would be analyzed by an actuary.) Revenue Ruling 74-307, 1974-2 C.B. 126.

2. Qualified Excess Benefit Arrangement ("QEBA")

Effective for years after December 31, 1994, state and local government employers may maintain "qualified governmental excess benefit plans" ("QEBA") under Code Section 415(m). Excess Plans are plans that provide benefits that cannot be provided under a qualified plan due to the limits on contributions and benefits. Excess Plans permit state and local government employers to provide benefits to their employees:

(1) without jeopardizing plan qualification because of the limits on contributions and benefits under Code Section 415,

(2) without jeopardizing a plan's status under Code Section 457 as an "eligible deferred compensation plan," and

(3) without the income that accrues to the qualified governmental excess benefit plan being taxable to the plan's government sponsor.

As we have discussed, we will not be addressing Code Section 415(m) and QEBAs in detail in this report, but in a separate report. However, for the purposes of determining retrospective benefit testing protocols, we think that it is relevant to consider the following provision that accompanied the enactment of Code Section 415(m):

> Nothing in the amendments made by this section shall be construed to imply that a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986) fails to satisfy the requirements of section 415 of such Code for any taxable year beginning before January 1, 1995.

P.L. 104-188. § 1444(c)(2). Under this grandfather section, retroactive testing for plan qualification purposes does not need to consider payments made prior to January 1, 1995.

3. Allocation of Benefits to After-Tax Employee Contributions

Contributions made on an after-tax basis to a defined benefit plan are deemed to be annual additions and subject to Code Section 415(c) limits (discussed below in more detail). Therefore, because the benefits have already been tested under Code Section 415(c), any portion of a defined benefit attributable to those after-tax contributions may be subtracted from the annual benefit before it is tested under Code Section 415(b). However, it is important to note that benefits that would be attributable to excess 415(c) contributions would not be "subtracted" from the annual benefit for 415(b) testing purposes.

a. Mandatory Employee Contributions

Treas. Reg. Section 1.415-3(d)(1) provides that the annual benefit attributable to mandatory contributions is determined by using the factors described in Code Section 411(c)(2)(B) "regardless of whether Section 411 applies to that plan." Regulations under Treas. Reg. Section 1.411(c)-1(c) establish the required method for allocating a portion of the defined benefit to the after-tax employee contributions for purposes of excluding this amount from the final annual benefit to be tested. The method requires calculation of the after-tax (not picked up) employee contributions (both mandatory employee contributions and any voluntary after-tax payments for service purchases unless tested under Code Section 415(n)), plus interest, at rates specified by the regulations. See Treas. Reg. § 1.411(c)-1(c). Generally, interest is computed at the rate provided by the plan until the last plan year before Code Section 411(a)(2) does not apply. Id. Thereafter, a plan should use a 5% interest rate factor.

Because governmental plans are exempt from Code Section 411, it is not clear how to apply this guidance to a governmental plan to which Section 411(a)(2) never applies. The Proposed Regulations provide that Code Section 411 should apply to this calculation even if the section is not applicable to the plan. Ice Miller commented on this point as follows:

> Because governmental plans are always exempt from Code Section 411, it is not clear how to apply this guidance to a governmental plan to which Section 411(a)(2) never applies. We have not located any IRS guidance on point. A literal reading suggests that, since Code Section 411(a)(2) never will apply to a governmental plan, actual plan assumptions should continue to be applied. We think that this reading is the best approach in the governmental plan context.

b. Voluntary After-Tax Contributions

The rules governing mandatory employee after-tax contributions are also applicable to voluntary after-tax contributions. Treas. Reg. § 1.415-3(d)(3). However, a special category of voluntary after-tax employee contributions – for permissive service credit purchases – is discussed below.

4. Employee After-Tax Contributions for Permissive Service Credit

Code Section 415(n) establishes a limitation structure for "permissive service credit" purchases, instead of relying on the existing Code Section 415(c) defined contribution limitations. This subsection allows Code Section 415 to be satisfied by a purchase of permissive service credit if either a modified 415(b) limit is met or a modified 415(c) limit is met. These limits can be applied on a participant-by-participant basis rather than choosing to apply the limit on a plan-wide basis. For example, some participants could satisfy the modified defined benefit limit when making a purchase of permissive service credit, while others could satisfy the modified defined contribution limit.

a. Modified 415(b) Limit

For purposes of Code Section 415(n), the defined benefit limit in Code Section 415(b) may be met by treating the accrued benefit derived from all permissive service credit as part of the member's annual benefit. Code Section 415(n)(2)(A) provides that, where the dollar limit under 415(b) is reduced for retirement before age 62, "the plan shall not fail to meet the reduced dollar limit under Subsection (b)(2)(C) [the age-reduced dollar limit] solely by reason of this subsection." Thus, the plan will not fail to meet the age-reduced dollar limit solely because the accrued benefit derived from the permissive service credit purchase is included in the 415(b) test.

b. Modified 415(c) Limit

For purposes of Code Section, only the dollar limit under Code Section 415(c) applies ($40,000 (adjusted for inflation to $42,000 for 2005 and $44,000 for 2006)) by treating all permissive service contributions as an annual addition under that limit.

c. Definition of Permissive Service Credit

The special testing rules apply only if the service being purchased qualifies as permissive service credit. Code Section 415(n)(3) defines "permissive service credit" as follows:

(3) PERMISSIVE SERVICE CREDIT.–For purposes of this subsection–

(A) IN GENERAL.–The term "permissive service credit" means service credit–

(i) recognized by the governmental plan for purposes of calculating a participant's benefit under the plan,

(ii) which such participant has not received under such governmental plan, and

(iii) which such participant may receive only by making a voluntary additional contribution, in an amount determined under such governmental plan, which does not exceed the amount necessary to fund the benefit attributable to such service credit.

Code Section 415(n)(3)(A). The proper interpretation of the Code Section 415(n) definition of permissive service credit is not a settled term. The Proposed Regulations do not address 415(n) issues. However, in private letter rulings, the IRS has taken the position that a benefit enhancement purchase (buying a higher multiplier on service a member already has in a plan) is not permissive service credit, because it would be a purchase for service in a plan under which the member has already received credit for that service. See PLR 200229051. Further, it is the IRS's position that permissive service credit must be related to an actual period of service or employment.

d. Nonqualified and Qualified Permissive Service

Permissive service credit can be categorized into two types. First, the Code defines "non-qualified service" as all permissive service that does not fall within one of the itemized types listed in Code Section 415(n)(3)(C). Although the Code does not use this term, we have termed the types of service included in this list as "qualified permissive service."

Code Section 415(n)(3)(C) defines "nonqualified service" as all permissive service except for the following types of service (which we have designated "qualified permissive service"):

- Service (including parental, medical, sabbatical, and similar leave) for the US government, any state or political subdivision thereof, or any agency or instrumentality of any of the foregoing.

- Service (including parental, medical, sabbatical, and similar leave) for an educational organization which is a public, private, or sectarian school which provides elementary or secondary education (through grade 12) as determined under state laws.

- Service for an association of employees of the U.S., state or political subdivision thereof, or an agency or instrumentality of the foregoing.

- Military service (non-USERRA covered) recognized by the governmental plan.

However, service under the first three (3) points above will be nonqualified service if recognition of the service would cause the member to receive a retirement benefit for the same service under more than one plan. Code Section 415(n) does not permit a plan to take more than five (5) years of nonqualified service into account, or to give members credit for any nonqualified service before the member has at least five (5) years of participation in the plan. Code Section 415(n)(3)(B).

It is important to note that "nonqualified service" is still one type of permissive service that is described in Section 415(n)(3)(A). Therefore, nonqualified service is available for purchase and may be tested under Code Section 415(n) special testing provisions.

e. Effective Dates

The service purchase testing provisions for permissive service credit under Code Section 415(n) are subject to a transition rule. The transition rule provides that the defined contribution

limits of Code Section 415(c) will not be used to reduce the amount of permissive service credit an "eligible participant" can purchase below what they were allowed to purchase under the terms of the plan as in effect on the enactment date, August 5, 1997. An "eligible participant" is an individual who first becomes a participant in the plan before the first plan year beginning after the last day of the calendar year in which the next regular session (following the date of enactment) of the governing body with authority to amend the plan ends.

Because the term "permissive service" is used in the grandfather provision, we believe that the IRS would apply a consistent definition of permissive service credit to the transition rule. As a result, the transition provision could permit greater purchases of nonqualified service and could permit permissive service purchases that exceed 415(c) and (b) limits, but would not extend to the purchase of service that did not meet the definition of permissive service credit.

5. Picked-Up Contributions

It is important to note that pre-tax contributions ("picked-up contributions"), whether mandatory or voluntary, are not treated as post-tax contributions. The benefit attributable to picked-up contributions is subject to 415(b) testing.

a. Code Section 414(h)

For governmental plans, "where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions." Code Section 414(h)(2). Consequently, if a governmental employer correctly picks up employee contributions, such contributions will no longer be included in the employee's gross income, nor will they be subject to income tax withholdings. Treas. Reg. § 1.402(a)-1; Rev. Rul. 77-462, 1977-2 C.B. 358. However, such contributions may be treated as employee contributions for all other purposes, including calculating benefits, state taxes, cost of living increases, salary increases, and bonuses. GCM 39540; PLR 8630073.[1] In addition, certain pick-up contributions are taken into account as "wages" for FICA purposes. Code Section 3121(v)(1)(B). The only way to obtain confirmation that the IRS approves of a pick-up is through a private letter ruling.

Revenue rulings have established the following requirements for an effective pick-up:

- The employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee;
- The employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan; and
- The pick-up is not effective prior to the last action required to be taken by the employer and/or the employee.

[1] It is important to note that private letter rulings do not have precedential value for other taxpayers.

Rev. Rul. 81-35; Rev. Rul. 81-36; and Rev. Rul. 87-10.

b. Pick-ups of Service Purchases under Governmental Plans

The IRS has approved the use of pick-ups for contributions to purchase service credit under governmental plans that have sought private letter rulings. In order to meet the requirements for an effective pick-up of an employee's service purchase, the above requirements for a pick-up must be met plus the following:

- The employee must elect to have the contributions for the service purchase made pursuant to a binding and irrevocable payroll reduction authorization.
- The payroll authorization specifies the amount by which the employee's compensation will be reduced in order to purchase the service credit and the duration of the authorization.
- The authorization cannot be revoked, except in limited circumstances involving termination of employment or death of the employee.

The most recent IRS rulings on service purchase pick-ups have included the following limitation language:

> This ruling is based on the conditions that (1) a participant who elects to purchase a particular type of service credit may not make more than one irrevocable election to purchase that type of service credit; and (2) a participant may make more than one irrevocable election to purchase service credit provided any subsequent election is for the purchase of a different type of service credit, is irrevocable, and does not alter or amend the terms and conditions of any prior election to purchase service credit.

PLR 200410025 (March 3, 2004); PLR 200347020 (November 7, 2003).

6. Amounts Attributable to Rollovers

Rollovers to a defined benefit plan are treated similarly to employee contributions for purposes of 415(b) testing:

> If the benefit under the plan is payable in any form other than the form described in subparagraph (A), or if the employees contribute to the plan or make rollover contributions (as defined in sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16), the determinations as to whether the limitation described in paragraph (1) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is equivalent to the benefit described in subparagraph (A).

Code Section 415(b)(2(B). This provision was amended by EGTRRA and is not reflected in the current rules. However, the Proposed Regulations treat rollovers in a manner similar to after-tax

contributions, so that the benefit attributable to the rollover must be converted in accordance with prescribed factors.

7. Amounts Attributable to Transfers between Qualified Plans

Under the current regulations, amounts attributable to a transfer from a qualified plan (a plan under Code Section 401(a)) are not included for 415(b) testing purposes. Treas. Reg. § 1.415-3(d)(1). See PLR 200347020 (Favorable ruling to make transfers from state defined contribution plan to defined benefit plan to purchase service); PLR 200345042 (Favorable ruling to make transfers from state defined contribution plan to defined benefit plan to purchase service); PLR 200335035 (Favorable ruling to make elective transfer from grandfathered 401(k) to defined benefit plan of amount necessary to buy service credit; transferred amounts held separately).

However, under the Proposed Regulations, transfers between defined benefit plans that must be aggregated are included for 415(b) testing purposes. Prop. Treas. Reg. § 1.415(b)-1(b)(3)(i)(A). But see PLR 200411046 (Favorable ruling approving elections to participate in defined contribution, defined benefit or hybrid plan with plan-to-plan transfers available at member's option on initial election; transfer available on subsequent elections to buy service credit with certain transferred amounts.)

8. Plan-to-Plan Transfers from a 457(b) or 403(b) Plan

There is an open question as to whether transfers made from 457(b) and 403(b) plans could also be excluded. Currently, federal regulations limit this exclusion to transfers from qualified plans. However, Code Sections 403(b)(13) and 457(e)(17) permit a direct trustee-to-trustee transfer of amounts from a 403(b) annuity or a 457 deferred compensation plan to a governmental defined benefit plan to purchase permissive service credit (either qualified or non-qualified) as defined in Code Section 415(n)(3)(A) and to repay contributions and earnings with respect to a previous forfeiture of service credit as defined in Code Section 415(k)(3). The final Treasury Regulations for 457 plans make it clear that the IRS believes that the term "permissive service credit" for purposes of Code Section 457(e)(17) must be defined consistently with Code Section 415(n), although the limiting provisions of 415(n) do not have to be applied. In addition, the preamble to the Final Regulations raises another issue:

> . . . Treasury and the IRS have concluded that section 415(n) does not apply to such a transfer in any case in which the actuarial value of the benefit increase that results from the transfer does not exceed the amount transferred.

68 F.R. 41232. The meaning of this comment is not clear and because the Proposed Regulations do not address Code Section 415(n), we do not currently have any guidance from the IRS as to whether a plan-to-plan transfer from a 457(b) or 403(b) plan to a qualified plan should be governed by the same rules as a plan-to-plan transfer from a qualified plan.

9. Restoration of Contributions

Code Section 415(k)(3) provides that any repayment of contributions (including interest) will not be taken into account for Code Section 415 purposes if the repayment is to a

governmental plan with respect to an amount previously refunded on a forfeiture of service credit under that plan or any other governmental plan maintained by the state or any local governmental employer within the same state. Thus, so long as the amount repaid does not exceed the amount refunded, plus interest, Code Section 415 should not apply. However, it is important to note that the Proposed Regulations do not agree with this interpretation, but rather treat the benefit attributable to the repayment as includible for 415(b) testing purposes. Prop. Treas. Reg. § 1.415(b)-1(b)(2)(ii).

D. AGE-BASED ADJUSTMENT TO LIMITS

1. Benefits Before Age 62

When the benefit begins before the participant reaches age 62, the Dollar Limit benefit limit generally must be actuarially adjusted so that the limit (as reduced) equals an annual benefit that is payable when the retirement benefit begins, and which is the equivalent of the Dollar Limit beginning at age 62. Code Section 415(b)(2)(C). The actuarial adjustments must be made in accordance with Code Section 415(b)(2)(E). Pre-EGTRRA, Code Section 415(b)(2)(F) limited the actuarial reduction for governmental plans to a $75,000 benefit payable at age 55 or, if the benefit began before age 55, the actuarial equivalent of a $75,000 benefit beginning at age 55.

a. Exception for Public Safety and Military

However, no age-based actuarial reduction is required for benefits beginning prior to age 62 for qualified participants. A qualified participant is defined as a participant:

> (i) in a defined benefit plan which is maintained by a State or political subdivision thereof,
>
> (ii) with respect to whom the period of service taken into account in determining the amount of the benefit under such defined benefit plan includes at least 15 years of service of the participant –
>
> > (I) as a full-time employee of any police department or fire department which is organized and operated by the State or political subdivision maintaining such defined benefit plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision, or
> >
> > (II) as a member of the Armed Forces of the United States.

Code Section 415(b)(2)(G)-(H). The interpretation of this provision has caused some concern among public pension plans. For example, it was not entirely clear whether the qualified participant had to be a sworn officer of a police department or whether any employee of a police department would be covered by this provision. The Proposed Regulations offer some increased flexibility for a "qualified participant," which is defined as:

> a participant in a defined benefit plan that is maintained by a state or local government with respect to whom the service taken into account in determining the amount of the benefit under the defined benefit plan includes at least 15 years of service of the participant ...[a]s a full-time employee of any police department or fire department that is organized and operated by the state or political subdivision maintaining such defined benefit plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such state or political subdivision.

Preamble to the Proposed Regulations. The proposed regulations would clarify that the application of this rule depends on whether the employer is a police department or fire department of the state or political subdivision, rather than on the job classification of the individual participant.

This exception is very beneficial to public safety officers and to other employees of police and fire departments, including non-public safety personnel. However, this definition does not cover employees who exercise police powers on behalf of a public agency but who are not employed by an agency that is called a "police department" (such as a Public Safety Department or Emergency Services Authority). An additional difficult situation arises with regard to emergency services personnel who are employed by an agency that is not called a "fire department" or "police department" but who are performing emergency medical services within the local government's jurisdiction. It remains to be seen whether the IRS will provide for further flexibility.

b. Exception for Disability and Death Benefits

In addition, the actuarial reduction for benefits beginning before age 62 does not apply to disability benefits or survivor benefits payable in the event of the death of the member provided under a governmental plan. Code Section 415(b)(2)(I).

c. Exception for Permissive Service Credit Procedures

A purchase of permissive service credit may be tested under Code Section 415(b) without regard to the reduction for early retirement.

2. Benefits After Age 65

For all members, if the retirement benefit under the plan begins after age 65, the Dollar Limit is increased so that it is the actuarial equivalent to an annual benefit beginning at age 65. Code Section 415(b)(2)(D). The actuarial assumptions used to make this conversion are set forth in Code Section 415(b)(2)(E).

E. ADDITIONAL SPECIAL RULES

1. Small Benefits

Code Section 415(b) has a number of additional special rules that may impact governmental employers. Code Section 415(b)(4) provides that defined benefit limits will not be

applied to reduce a participant's benefits when total annual benefits are $10,000 or less. However, this limitation only applies "if the employer has not at any time maintained a defined contribution plan in which the employee has participated." Code Section 415(b)(4)(B).

2. Less than 10 Years of Participation

When an employee has less than ten years of participation in a defined benefit plan, the basic Code Section 415(b) Dollar Limit (or the minimum $10,000 exemption from testing) is reduced by 10% for each year less than ten in which the employee participated in the defined benefit plan for other than death and disability benefits (but not below 1/10th of the Dollar Limit). Code Section 415(b)(5) and Treas. Reg. § 1.415-3(g).

F. OPTIONAL FORMS OF BENEFITS

Benefits in a form other than a straight life annuity must be actuarially adjusted to a straight life annuity beginning at the same age in accordance with the otherwise applicable rules. For example, annuity benefit forms including a post-retirement death benefit or an annuity providing for a guaranteed number of payments must be adjusted for purpose of applying the Code Section 415(b) limit. See Treas. Reg. § 1.415-3(c)(1)(ii). No adjustment is required for certain benefits, including the actuarial value of a qualified joint and survivor annuity ("QJSA") that is fully or partially subsidized, the value of benefits not directly related to retirement benefits, and certain cost of living increases. See Treas. Reg. § 1.415-3(c)(2).

Code Section 415(b)(2)(E)(i) provides that "for purposes of adjusting any limit under subparagraph (C) [adjustment to dollar limit before age 62] and ... for purposes of adjusting any benefit under subparagraph (B) [adjustment for other forms of benefits], the interest rate assumption shall not be less than the greater of 5% or the rate specified in the plan."[2] With respect to adjusting a different form of benefit (under Code Section 415(b)(2)(B)), different interest rate assumptions are used in the case of a form of benefit subject to Code Section 417(e)(3). Code Section 415(b)(2)(E)(ii). However, because SDCERS is a governmental plan which is not subject to Code Section 417(e)(3), these different interest rate assumptions would not be applicable. Rev. Rul. 98-1, Q&A-3 (plans that are not subject to Code Section 417(e)(3), such as governmental plans, are not subject to the interest rate requirement under Section 415(b)(2)(E)(ii)).

Thus, for purposes of converting a form of benefit to a straight life annuity, the interest rate assumption should not be less than the greater of 5% or the rate specified in the plan (i.e., the rate used under the plan for actuarial equivalence for that specific benefit form). See IRS Announcement 95-99.

G. COST-OF-LIVING ADJUSTMENT OF CODE SECTION 415(b) LIMITS

Cost of living adjustments to a member's benefits are permitted under Code Section 415(d) and Treas. Reg. § 1.415-5(a)(3). By regulation, the adjusted dollar limitation "is applicable to . . . employees who have retired or otherwise terminated their service under the

[2] Code Section 415(b)(2)(E)(iii) also provides that these same interest rate assumptions should be used in adjusting the 415(b) limit when benefits begin after age 65.

plan with a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive such benefits, as long as the plan specifically provides for the adjustment." Treas. Reg. § 1.415-5(a)(3).

With regard to the COLA on SDCERS benefits, the current regulations provide that no adjustment to the benefit's value is necessary for post-retirement cost of living increases "to the extent that such increases are in accordance with" Code Section 415(d) and Treas. Reg. § 1.415-5. Treas. Reg. § 1.415-3(c)(2)(iii). The correct interpretation of this phrase is a matter of some debate. IRS has said informally and in a private letter ruling that they think an automatic post-retirement increase must be initially reflected in the value of the member's benefit being tested, thus resulting in an initial actuarial reduction of the 415(b) limit. This reduction can be considerable. We do not think that this type of adjustment accurately reflects the regulations, which reflect an incremental approach – that a COLA does not cause an adjustment "to the extent" it is consistent with subsequent increases in the Code Section 415 limits. In addition, there seems to be no reasonable way to project what the increases to the IRS limit will be (by federal law the increases must be "similar" to the Social Security COLA calculations), making it virtually impossible to reflect an incremental COLA adjustment into a reduced 415(b) limit. Code Section 415(d)(2).

The Proposed Regulations incorporate the approach the IRS had taken in informal guidance and provide that a fixed, automatic COLA has the effect of reducing the 415(b) limit. As indicated, this reduction can be significant and would result in significantly more members of governmental plans approaching the 415(b) limit. Ice Miller and many others have submitted comments on this point, but it remains to be seen whether the IRS will address those comments by revising its stance in final regulations.

H. Consideration of an Alternate Payee's Benefits For Testing Purposes

Benefits payable to an alternate payee under a qualified domestic relations order are treated as part of the member's benefit for purposes of applying the benefit limits under Code Section 415. IRS Notice 87-21, Q&A-20; see also Announcement 95-99, Q&A-17.

I. Testing of the Survivor Portion of a Benefit

The rules which apply to a member's benefit also apply to a survivor's benefit. Under Code Section 415(b)(1), the annual benefit may not exceed the applicable dollar limit ($170,000 for 2005). The Code defines "annual benefit" as "a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions ... are made." Code Section 415(b)(2)(A) (emphasis added). If a benefit under the plan is payable in any form other than this form,

> the determinations as to whether the [415(b)] limitation ... has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by adjusting such benefit so that it is the equivalent to the benefit described in subparagraph (A). For purposes of this subparagraph, any ancillary benefit which is not directly related to retirement income benefits shall not be taken into account; and that portion of any joint and survivor annuity which constitutes a

qualified joint and survivor annuity (as defined in section 417) shall not be taken into account.

Code Section 415(b)(2)(B).

Thus, the benefit that is subject to testing is a straight life annuity, and any other benefit under a plan which is payable in a form other than a straight life annuity (other than a qualified joint and survivor annuity) must be converted to a straight life annuity in order to pass 415(b) testing. In essence, even if a benefit actually being paid is not a straight life annuity, it still should have been converted to a straight life annuity and tested under Code Section 415(b). Thus, upon the death of the retiree, there would be no need for a "conversion" of the survivor's benefit or a change to the existing 415(b) limit as applied to the retiree's benefit. Rather, upon the death of a retiree, the survivor's benefit continues to be tested against the retiree's benefit limit. (This would also be true of a qualified joint and survivor annuity, even though it is not converted to a straight life annuity for testing purposes, because such benefit is exempted from the conversion requirement.)

J. AGGREGATION OF TOTAL SDCERS BENEFITS FOR TESTING PURPOSES

Under a multiple employer plan, two (2) or more employers that are not part of a related group participate in the same plan. In applying the Code Section 415 limits to such multiple employer plans, Treas. Reg. § 1.415-1(e)(1) provides that for a participant in a multiple employer plan, benefits or contributions under the plan attributable to such participant from all of the employers maintaining the plan and compensation from all the participating employers must be taken into account. Generally, if the employers had maintained separate plans this rule would not apply, and the Code Section 415 limits would be separately determined for each employer because they are not part of a related group.

IV.
APPLICATION OF CODE SECTION 415(b) TO SDCERS AND RECOMMENDATIONS

The purpose of this Section of this Compliance Strategy Report is to relate the requirements of Code Section 415(b) as outlined in the previous Section to SDCERS.

A. PLAN DOCUMENT PROVISIONS

SDMC § 24.1010(h) (*per pending amendment*) provides that employee contributions to, and benefits from, SDCERS must comply with the Code Section 415 limitations on contributions and benefits. The provision further establishes the calendar year as the testing year and permits SDCERS to modify contributions as necessary to ensure compliance with Code Section 415. The Board Rules do not contain any provisions relating to Code Section 415 compliance, nor do any other policies or documents of which we are aware.

B. OPERATIONAL COMPLIANCE

1. Definition of the Annual Benefit for 415(b) Testing

Under Code Section 415(b), the benefit that is subject to testing is the benefit payable annually in the form of a straight life annuity ("SLA") with no ancillary benefits to which employees do not contribute and no rollover contributions are made. Code Section 415(b)(2)(A).

a. Straight Life Annuity

The benefit that will be tested is the SLA plus the value of the DROP benefit (if applicable) on a straight life basis.

For purposes of calculating the SLA, the value of any subsidy provided as part of a qualified joint and survivor annuity was included only when the beneficiary was other than a qualified spouse. We understand that using the SDCERS "maximum benefit" would generally accomplish this purpose.

b. Post-Retirement Increases

SDCERS members receive two post-retirement adjustments: a fixed COLA and a 13th Check. Certain groups receive additional adjustments: a Supplemental COLA and benefit increases under the Corbett settlement. The protocols in Exhibit A and Exhibit B treat the fixed COLA as being within the Code Section 415(d) adjustment. With respect to the Supplemental COLA, 13th Check and Corbett Settlement, these benefits will be treated as part of the annual benefit for both prospective and retrospective testing. However, the value of the post-retirement $2000 death benefit is not included for 415(b) testing. Treas. Reg. § 1.415-3(a)(2)(i)(B).

- **13th Check**

In our various meetings, the question has arisen how to treat the 13th Check for testing purposes because under the Municipal Code the 13th Check is treated as a contingent benefit. In order to respond to the question, we considered the history of the 13th Check. From 1/1/95 to now, in all but two years the 13th check was paid in full. In 2003 no 13th Check was paid and in another year over 99% of the 13th Check was paid. Based upon this history, it was decided that for 415(b) testing purposes, the 13th Check will be treated as an additional annual benefit. (Note: This is consistent with the treatment described in the Rollover Compliance Report and VCP Filing.)

- **Supplemental COLA**

For 415(b) testing purposes, the supplemental COLA is already treated as an annual benefit. This benefit is referred to in the testing chart as the "Star COLA."

- **Corbett Settlement Amounts**

For purposes of 415(b) testing, the Corbett settlement amount will be treated as part of the annual benefit.

The Corbett-covered group is a closed group.

- **Andrecht Settlement Amounts**

The Andrecht Settlement amounts were included in the calculation of the annual benefit provided by SDCERS. Therefore, no additional adjustment is required for this settlement (in contrast to the Corbett Settlement, which is a post-retirement adjustment).

c. Factors used in Calculating Actuarial Equivalents

Where necessary to calculate actuarial equivalents, the applicable mortality assumptions of GAM 83 through December 31, 2002, and thereafter GAR 94, pursuant to Rev. Rul. 2001-62, 2001-2 C.B. 632, were used. An eight percent (8%) interest assumption was used.

d. Exclusion of Recipients of Ancillary Benefits

It has been determined that individuals who are receiving benefit payments that are not directly related to retirement benefits (such as pre-retirement disability and death benefits and post-retirement medical benefits) will be excluded from testing.

SDCERS also anticipates excluding all non-taxable disability benefits (these would be line of duty disability benefits). However, we note that an IRS ruling is necessary as to the status of these items and we are not aware that SDCERS has ever obtained such a ruling.

For the pre-retirement disability benefits, SDCERS will still have to apply the 100% of compensation screen. For the combined pre-retirement disability benefit and the pre-retirement death benefit, SDCERS will apply an incidental benefit test, such as the 25% of cost test. This will be in addition to, and separate from, the 415 limits.

2. TAMRA Election

SDMC § 24.1010(b) (*prior to pending amendment*) purports to make the TAMRA election for SDCERS benefits. However, the pending amendment to SDMC § 24.1010 would remove the language referencing the TAMRA election, as it is not clear that the requirements of the election were satisfied. We recommended that the TAMRA election should be treated as repealed because it would impose the private sector plan limits on certain SDCERS members, and because it is our understanding that SDCERS operated as though the TAMRA election had been repealed.

3. Age Adjustments Made in 415(b) Testing

a. Benefits After Age 65

For all members whose retirement benefit begins after age 65, the Dollar Limit was appropriately adjusted, as described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

b. Benefits Before Age 62 – Other than Qualified Participants

For all members other than Qualified Participants whose retirement benefit begins before age 62, the Dollar Limit was appropriately adjusted, as described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

c. Definition of Qualified Participants

As discussed above, the reduction in the dollar limitation for benefits which begin before age 62 does not apply to Qualified Participants. It is important to keep in mind that the group of public safety employees who may take advantage of this exception is not necessarily consistent with SDCERS' public safety member classification. For example, since EMTs were moved into the fire department several years ago, they could be included as a Qualified Participant (if they meet the service requirements). However, lifeguards were moved into the fire department fewer than 15 years ago; therefore, they do not clearly fall within the exception.

We note that the Proposed Regulations provide further guidance as to the public safety employees who may take advantage of the exception. Following is a suggested checklist for identifying Qualified Participants:

- Is the member credited in SDCERS with at least 15 years of service as an employee of any police department or fire department of the employer? If no, then apply pre-age 62 screen. If yes, proceed to next question. Note: The 15 years must be with an SDCERS employer, not via reciprocity.[3]

- Was the member a full-time employee of any police department or the fire department for all of those 15 years of service? If no, then apply pre-age 62 screen. If yes, do not apply pre-age 62 reduction. Count a person as a full-time employee of the department even if they are not a public safety officer. For example, if a person was a secretary in the fire department, they are a Qualified Participant. Service with the departments should be counted, including all periods of service, e.g., count such service that occurred before termination and reemployment. For example, if a member worked on probation for his first six months and then purchased that time, it should be included. A second example is a person who worked for one of the departments for three years, then left and took a refund. He then returned to the department and purchased those three years. They should be included.

SDCERS staff has asked whether this exception for public safety officers requires that all fifteen (15) years of service be with the same department, or whether the service might be spread among two or more departments. In addition, SDCERS staff has asked whether police and military service can be combined to meet the 15-year requirement. The language of the Code and related regulations are very ambiguous on this point. While the Code language requires fifteen (15) years of service for any police or fire department organized and operated by the

[3] If the City plan, the Airport plan, and the Port plan are considered as separate plans, the Proposed Regulations may not permit combining service.

governmental employer maintaining the plan or military service, the Proposed Regulations require service either for any police or fire department or military service. Therefore, we are unable to opine on this point, although we believe that the IRS should accept any combination of public safety and military service in reaching the 15 year mark. We therefore are comfortable with the testing being done using the combination of all San Diego police and fire department service and military service. The IRS, of course, may request a different approach in the VCP filing on Code Section 415(b).

In addition, we agreed we would add a discussion of park rangers, who are not in the police department, but who exercise police powers in the City parks. We believe that the IRS should treat them as qualified participants if they meet the 15-year test. Therefore, we should identify this group under the definition of qualified participants.

d. Exclusion of Pre-Age 62 Reduction for Disability or Death Benefits

The pre-age 62 reduction would not be applied to a SDCERS disability benefit or to a death benefit.

4. **10-Year Adjustment**

SDCERS must identify those retirees who have fewer than ten (10) years of service with SDCERS, exclusive of reciprocity and exclusive of service purchases. Those retirees would have a reduced 415(b) test amount – for example, if the retiree only had five (5) years of service with SDCERS (exclusive of reciprocity and service purchases), the retiree's age-adjusted limit would be 50% of the age–adjusted limit. The limit can never be lower than 10% of the otherwise applicable limit. We realize this could create failures because of several design elements (i.e., the Port and Airport Plans have a five year vesting schedule, reciprocity provisions that allow for crediting service in other plans, a pre-1992 group who had less than 10 years of service but were vested as a mandatory retirement age group, and the SPSP "5+5" group). These adjustments are described in Exhibit A with respect to retrospective testing and Exhibit B with respect to prospective testing.

C. AMOUNTS EXCLUDED FROM TESTING

Following is a discussion of the elements that have been considered for exclusion in the screening and testing process.

1. **After-Tax Employee Contributions**

SDCERS would normally identify the portion of the annual benefit that is attributable to after-tax employee contributions, which benefit could be "subtracted" from the annual benefit. In order to perform this calculation, SDCERS would have to be able to identify mandatory employee contributions that were made prior to the adoption of the pick-up and any voluntary post-tax contributions (including after-tax contributions for service purchases). However, we ultimately recommend that in the testing protocol the benefit attributable to after-tax employee contributions not be excluded from 415(b) testing, because those after-tax contributions were not tested under 415(c). This would be consistent with Code Section 415(n) testing.

a. Mandatory Employee Contributions

SDCERS implemented a pick-up of mandatory contributions in 1987[4] for all contributions made by the employer. Prior to that time mandatory employee contributions were made on an after-tax basis; therefore, under the IRS regulations the benefit attributable to those mandatory contributions would be excludible from 415(b) testing. However, if those mandatory contributions exceed the 415(c) limits, the benefit attributable to the excess contribution would not be excludible. These pre-87 contributions will only be "backed out" from the 415(b) testing in cases where a failure has been identified in the testing group under the prospective methodology. The initial screen will leave them in.

b. Voluntary USERRA Contributions

It is our understanding that USERRA contributions are subtracted from any differential pay for the member. However, if the member did not receive differential pay, the member would be given the opportunity to pay those contributions on an after-tax basis. Therefore, SDCERS would be permitted to exclude the benefit attributable to the post-tax USERRA contributions from 415(b) testing, if the post-tax USERRA contributions would not have exceeded the 415(c) limits in the year of service.

c. DROP Contributions

SDMC § 24.1404(c)(4) provides that DROP contributions are made pursuant to a 414(h) pick-up. Therefore, the benefit attributable to these contributions would be included in 415(b) testing.

d. Voluntary Contributions for Permissive Service Credit Purchases; Missed Contributions

As noted above, the amount contributed for permissive service credit may either be tested under a modified 415(c) or 415(b) test. If the permissive service credit purchases exceeded the modified 415(c) limit, then the modified 415(b) test would have to be applied.

When SDCERS has determined that contributions have not been remitted for a period of service, the member is "billed" for these contributions as a pre-condition for receiving credit for that period of service. If those missed contributions are paid by the member with after-tax dollars, those contributions would be tested under Code Section 415(n) using the modified 415(b) test.

e. Voluntary Contributions for Non-Permissive Service Credit Purchases

Voluntary employee after-tax contributions that are made for non-permissive service credit purchases must be tested under Code Section 415(c). If those voluntary after-tax contributions were appropriately tested under Code Section 415(c) at the time of purchase, the benefit attributable to those contributions may be excluded from 415(b) testing.

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[4] This date was provided by staff on 12/7/2005.

f. Proposed Correction Approach

Because SDCERS has not had a 415(c) testing program in place prior to this compliance review, we have suggested as a correction approach that no after-tax employee contributions would be excluded from 415(b) testing. See Exhibit A.

Starting with January 1, 2007, and on a prospective basis, 415(c) testing will be applied. Testing for 2006 will be handled in a self-correction manner. We also recommend, as a going-forward matter, that SDCERS keep a record of the type of service purchased and the source of the purchase. This will be done by reprogramming PensionGold (the SDCERS operating system).

PensionGold currently has fields with drop down selections that are used to identify the sources of money received for the payment of Purchase Service Contracts:

Payment Type Choices:

401k Transfer
Balance Adjustment
Cashless Transfer[5]
Lump Sum Payment
Manual
Rollover
SPSP Transfer
Transmittal

If the Rollover option is selected as the Payment Type, the "Rollover information" section is enabled. This section has a "Type" field with the following selection options:

401(k)
403(b)
457
Individual Retirement Account
Other Qualified Plan

Other fields in the Rollover information section include:

Acct. Name
Acct. Number
Acct. Holder

Each Payment received is identified in the system as "Pre or Post tax," as well as tied directly to a specific contract which identifies the service purchase type.

[5] This type of transfer is addressed in a separate VCP filing and Report.

To provide for accurate prospective 415(c) testing, we recommend that an additional payment type be identified as 457(b) or 403(b) direct transfer to identify those situation where permissive service credit is being purchased. We also recommend that the specific type of service being purchased be identified so that it can be determined that an appropriate source of funding was used.

2. Rollovers

The amount of the annual benefit that is attributable to rollovers may be excluded from 415(b) testing. As noted above, the benefit attributable to a rollover must be calculated in a manner permitted by the IRS. The properly calculated benefit attributable to the rollover could be "subtracted" from the annual benefit for testing purposes. Appropriate conversion factors for rollover purchases will be utilized.

3. Transfers from a Qualified Plan

With regard to transfers from a qualified defined contribution plan, the amount attributable to the transfer would be excludible from 415(b) testing using IRS prescribed factors. However, if there is a transfer from another defined benefit plan where aggregation is required (because, for example, the plans are maintained by the same employer or related employers), then the total benefit would be tested under 415(b). If the transfer is not from a defined benefit plan where aggregation is required, then the benefit attributable to the transferred amount could be "subtracted" from the annual benefit for testing purposes. Appropriate conversion factors for transfers in this situation will be utilized. **Note:** In this case, the employers participating in SDCERS do not maintain another defined benefit plan.

4. Transfers from a 403(b) or 457(b) Plan

Current IRS guidance does not directly address a transfer from a 457(b) or 403(b) plan for testing purposes. Retrospectively, we are not backing out 457(b) and 403(b) transfers. Prospectively, the chart below will be followed.

5. Purchase of Service Chart

The following chart identifies the various purchases that may be made under the Municipal Code[6] and our assessment of whether they would appropriately be categorized as permissive service credit – qualified or non-qualified – and the types of contributions that could be used for the purchase. For the category "permissive service," we are assuming that SDCERS assures that there is no double-counting of service and only one year of credit may be received for any 12 month period. For the category "sources" we are referring to whether all types of employee contributions can be made for the purchase – after-tax contributions under 415(c), after-tax contributions under 415(n), rollovers, plan-to-plan transfers from a DC qualified plan, and plan-to-plan transfers from a 457(b) or 403(b) plan. With respect to transfers, the final 415 regulations may offer more guidance for prospective testing.

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[6] Board Rules 10.00-10.40 describe Board policy with respect to the purchases that are set forth in the Municipal Code.

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
Missed Contributions	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1301 – LTD	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1302 – Probation. Employee contributions only	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1303 – City Service	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1303 – 1981 Plan – waiting period	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1304 – Part-time, hourly pre 1/2/97	Yes (no double counting)	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1305 – Reinstatement – pre	Yes (no double counting)	Qualified	All	Back out benefit attributable to rollovers,

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
1/2/97	415(k) Service			DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1306 – Repayment of refunds – contributions plus interest	Yes 415(k) Service	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(a) – Approved leave (one year) by payment of "employee cost" for leaves that begin before 2/1/97	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(b) – Approved leave (more than one year) by payment of employee and employer cost for leaves that begin before 2/1/97.	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1307(c) – After 1/1/97, LTD, FMLA, leaves without pay.	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1308 – Field of Membership	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b) transfers, based on IRS factors; use modified 415(b) testing under 415(n).
24.1309 – Military Service: USERRA service (Per	Yes	Qualified	All	Back out benefit attributable to rollovers, DC and 457(b)/403(b)

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
SDCERS, this only covers USERRA service.)				transfers, based on IRS factors; use modified 415(b) testing under 415(n). Note: Electing this for convenience could be treated separately from all other service.
24.1312 – 5 year purchase – No period of service identified	Not permissive service	n/a	Rollovers, DC transfers, picked up contributions, after-tax employee contributions	For rollovers and DC transfers, back out benefit attributable to rollovers and DC transfers, based on IRS factors. For after-tax employee contributions, test under 415(c) regular limits
24.1312 – 5 year purchase. If a period of service is identified, then purchase may be made with after-tax employee contributions	In order to be permissive service credit, IRS non-binding ruling requires period of service or employment. New Board Rule 10.60 establishes procedure for definition as permissive service	Depends on certification provided – may be qualified or nonqualified permissive service. If non-qualified may only be purchased by employee with 5 years of service and total purchase may not exceed 5 years.	After-tax employee contributions	Use modified 415(b) testing under 415(n).
24.1312 – 5 year purchase – A period of service identified – purchase is made with 457(b) or 403(b) transfer	In order to be permissive service credit, IRS non-binding ruling requires period of service or employment. New Board Rule 10.60 establishes procedure for definition as permissive	N/A	Transfer from 457(b) or 403(b) plan	Back out benefit attributable to 457(b)/403(b) transfers, based on IRS factors * Use modified 415(b) testing under 415(n).

SDMC § /Type	Permissive Service	Qualified or Nonqualified	Sources	Treatment for 415(b) Purposes
	service			

6. 401(h) Amounts

Payments made from the 401(h) account do not count toward the Code Section 415(b) limit. Treas. Reg. § 1.415-3(d)(2)(ii). However, Code Section 415(l) provides that contributions allocated in an "individual medical account" shall be treated as an annual addition to a defined contribution plan, but are only subject to the 415(c) dollar limit (not the compensation limit).

However, it is our understanding there are currently no SDCERS reserves left to pay this 401(h) benefit. Consequently, retiree medical is either paid from other sources or not paid at all.

7. Aggregation of Payments to Alternate Payees

For purposes of 415(b) testing, SDCERS must aggregate payments to the member with any payments to alternate payees under the community property laws, including payments made pursuant to child support and spousal support orders. PensionGold was modified as of January 1, 2003, so that all payments made with respect to a member are "associated" with the member. In addition to payments to alternate payees, the "association" also includes deductions from the member's benefit such as an IRS levy. In order to have accurate 415(b) testing both prospectively and retrospectively, all "disassociated" payments must be associated with the appropriate SDCERS member. That "association" was done only with respect to the "initial failure" group of 89. (Please note that the initial group screen did include a 20% load for other than member payments.) Therefore, the total population has not been "associated." The 89 initial failures were "associated." Prospectively, SDCERS must associate all members when tested.

D. CLASSIFICATION OF EMPLOYER CONTRIBUTIONS

SDCERS staff has indicated that the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution. The result is that the benefit attributable to any employer contribution (regular, offset, and pick-up) will be subject to 415(b) testing. This is the appropriate result under Code Section 415(b).

In order to enhance future compliance efforts, we strongly recommend that SDCERS and the plan sponsors use the term pick-up in the manner provided for in Code Section 414(h)(2).

E. QUALIFIED EXCESS BENEFIT ARRANGEMENT ("QEBA")

We note that Ordinance No. O-18390, adopted on March 19, 2001, authorizes the establishment of a qualified governmental excess benefit arrangement (known as the Preservation of Benefit Plan) by SDCERS to pay benefits in excess of the Code Section 415 limitations. SDMC §§ 24.1601 to 24.1608 provide basic provisions regarding the establishment of a QEBA. However, we understand that there was no separate plan document for the QEBA

and the above-referenced provisions of the SDMC do not contain sufficient detail to address all aspects of the operation of the QEBA. For these reasons, we recommended during our September discussions that SDCERS establish the QEBA through a separate plan/trust document containing detailed provisions regarding the plan. That document has now been drafted. This is covered in a separate report, and will be submitted to the IRS in a PLR.

F. CONCLUSIONS REGARDING RETROSPECTIVE 415(b) TESTING

1. Definition of Tested Group

SDCERS, working with Ice Miller and Cheiron, developed a protocol for determining whether there have been 415(b) violations in prior years. This protocol began by identifying the entire population of 5530 retirees. That total was initially reduced by disabilitants who were not receiving a service retirement (490). The group was then reduced to retirees who began receiving benefits on or after January 1, 1995. After removal of 26 records reflecting deceased or suspended participants, this remaining group consisted of 2041 individuals, who were then tested under 415(b). See Exhibit A for the assumptions that were used in testing this group. This date (1/1/95) was selected for the following reasons:

From a Benefit Standpoint

1. The DROP benefit is one of the potential "causes" of 415(b) failures. The DROP benefit was initiated after January 1, 1995 (April 1997). Therefore, all DROP recipients are being tested under the new protocol.

2. Using the 1/1/95 date captures all of the Corbett and Andrecht settlement amounts.

3. Service purchases are another potential cause of 415(b) failures. The largest service purchase programs were initiated after January 1, 1995.

4. Multiplier increases are another potential cause of 415(b) failures. The most recent multiplier increases took effect in 1997 and 2002.

From the Code Standpoint

1. The grandfather provision enacted with Code Section 415(m) applies to benefits prior to January 1, 1995.

2. The grandfather provision enacted with Code Section 415(n) applies to any service purchase in effect on August 5, 1997.

2. "Screens" Used in Retrospective Testing

a. First Screen

Cheiron has run its 415 testing at 90% of the applicable 415(b) limit with the assumptions set forth in Exhibit A and discussed above. This first screen was conservative:

- It tested the benefit derived from all contributions, including rollovers, plan-to-plan transfers, pre-tax employee contributions and mandatory contributions, service purchases, and employer contributions.

- It did not apply the more favorable age-reduction rules for qualified public safety participants.

- It included DROP accruals computed based upon the actual option selected by the member.

- It reflects the annual benefits, which were adjusted by a 20% increase to take into account co-annuitant issues.

This first screen resulted in approximately 89 persons being identified as exceeding the 415(b) limits, out of a pool of 2,041 benefit recipients.

b. Second Screen

These 89 individuals were re-examined by SDCERS staff and Cheiron by doing the following:

- Identify rollover and transfer amounts that were used for service purchase for service retirement, so that that the benefit attributable to those rollover amounts could be backed out of the benefit calculation.

- Identify transfer amounts (from the DC plans, i.e., the SPSP and the 401(k) Plan) that were used for service purchase for service retirement, so that the benefit attributable to those transfers could be backed out of the benefit calculation.

- On the joint and survivor elections - if the benefit is a qualified (spouse) survivor annuity (either 50% or 100%), test under more favorable rules under Code.

- Check if any of the failure participants have QDROs which have to be aggregated and, if so, aggregate the benefits.

- Determine the member's service history -- what departments did the member actually work in. The purpose would be to determine if the member should be categorized as public safety. As discussed above, we suggested including those with 15 years in either a police or fire department. As we have indicated above, the qualified participants do not have to be sworn. Service purchases, other than purchases of public safety employment (such as probationary service or restored time), do not count toward the public safety years. Service purchases of public safety employment do count.

The second screen did not exclude from testing any after-tax employee contributions, whether mandatory or voluntary. The second screen also did not include transfers from the 457(b) plan or from a DB plan.

The resulting number of 415(b) violations was 29.

3. Payments of Excess Benefits from the Preservation of Benefit Plan

After completion of the above screens, the excess benefits of the affected individuals will be paid by the plan sponsors pursuant to San Diego Municipal Ordinance O-18930, March 19, 2001 (the "Ordinance"), which establishes the Preservation of Benefit Plan ("POB Plan") as a qualified governmental excess benefit arrangement within the meaning of Code Section 415(m).

We have recommended to SDCERS that a private letter ruling be pursued in order for the IRS to approve the POB Plan as a qualified excess benefit arrangement under Code Section 415(m) and to approve a rabbi trust for the POB Plan under Rev. Proc. 92-64, 1992-33 I.R.B. 11. In the interim, SDCERS has determined that it will seek direct payment from the plan sponsors of the excess benefits.

Once the POB is in place, SDCERS staff wants to use a "modified cliff approach." Under this approach, a retiree would be paid his/her full monthly benefit from the qualified SDCERS plan until the "modified cliff" date is identified. The modified cliff is determined by first identifying the amount of 415(b) excess for the year and determining how many months of benefits would have to be paid from the POB. Then, that amount is further adjusted to make sure that the member is receiving a portion of his/her benefit from the qualified plan in order that deductions from that benefit can continue.

A very simplified example demonstrates this approach: assume that a retiree is receiving a straight life annuity and has an excess benefit that equals 1/12 of his annual benefit. That would mean that he would receive 11 months of benefit from the qualified plan and one month of benefits from the POB. But if the retiree has a deduction from his benefit that equals ½ of his monthly benefit, then he would receive ½ of his monthly benefit from the qualified plan in month 11 and month 12 (in order to have dollars available for the deductions to take effect) and he would receive ½ of this monthly benefit from the POB in month 11 and month 12.

G. Conclusions Regarding Prospective Testing

1. Definition of Tested Group

Retrospective testing will cover the period 1995 through June 30, 2005. Testing for the balance of 2005 and 2006 will be handled as a self-correction using the retrospective testing method.

All members who retire on and after January 1, 2007, will be tested in accordance with the 415(b) protocols being developed by Cheiron, a draft of which is set forth in Exhibit B. To the extent information is available on pre-pick-up employee contributions, the after-tax contributions will be backed out for 415(b) testing.

2. "Screens" Used in Testing

Linea will build screens based upon PensionGold (the software used by SDCERS) fields.

3. Payments of Excess Benefits from POB Plan

Payments of excess benefits that result from prospective screening will be accomplished as stated above.

V.
OVERVIEW OF LAW WITH RESPECT TO DEFINED CONTRIBUTION LIMITS

Annual additions made or deemed to be made to a defined contribution plan are subject to the limits under Code Section 415(c). This test is applied on an annual basis and it is applicable to those governmental defined benefit plans that provide for after-tax employee contributions or certain purchases of service. Thus, after-tax employee contributions and after-tax payments for purchases of service are tested under the Code Section 415(c) limits, in the same manner as contributions to a separate defined contribution plan. Treas. Reg. § 1.415-3(d)(1).

A. The Dollar Limit on "Annual Additions"

1. Current Limits

The defined contribution limits contain both a Dollar Limit and a percentage of compensation limit ("Percentage Limit"). EGTRRA increased the Dollar Limit for defined contribution plans from $35,000 to $40,000 for plan years beginning in 2002. This $40,000 dollar limit is subject to more rapid indexing, with annual cost of living adjustments in $1,000 increments instead of the current $5,000 increments. For 2006, the limit is $44,000.

Under prior law, the Percentage Limit did not permit contributions to exceed 25% of compensation. However, EGTRRA amended this limit for plan years beginning in 2002, and permitted annual additions to defined contribution plans of up to 100% of the participant's compensation, or $40,000 (as adjusted for inflation), whichever is less. For purposes of this definition, "compensation" includes both elective deferrals to a 401(k) plan or 403(b) plan and amounts contributed or deferred by the employer at the employee's election under a cafeteria plan, qualified transportation fringe benefit plan, or a 457 deferred compensation plan.

Certain contributions are not included in the definition of "annual additions" that are tested under Code Section 415(c). Mandatory employee contributions that are picked-up by an employer, or service purchase payments paid for by pre-tax (picked up) installment payments, simplify Code Section 415 testing because mandatory contributions or service purchase installment payments picked up pursuant to Code Section 414(h)(2) are not required to be treated as contributions to a separate defined contribution plan. However, the resulting benefit must be tested under Code Section 415(b) upon separation.

Additionally, Treas. Reg. § 1.415-6(b)(2) provides that a transfer of funds from one qualified plan to another is not an "annual addition" subject to testing under Code Section 415(c). Furthermore, Treas. Reg. § 1.415-6(b)(3) provides that the following types of contributions are not treated as employee contributions and thus are not "annual additions":

(i) Rollover contributions, and

(ii) The direct transfer of employee contributions from one qualified plan to another.

Additional exceptions from the 415(c) limits include USERRA contributions and restoration of forfeited benefits, which are discussed below.

2. **The Limitation Year**

The limitation year for 415(c) testing purposes is determined in the same fashion as for 415(b) testing purposes.

3. **Code Section 415(k)(3): Repayment of Cash-Outs**

Section 415(k)(3) provides that any repayment of contributions (including interest) will not be taken into account for Code Section 415 purposes if the repayment is to a governmental plan with respect to an amount previously refunded on a forfeiture of service credit under that plan or any other governmental plan maintained by the state or any local governmental employer within the same state.

4. **Testing of USERRA Service Purchases**

Special Code Section 415 testing rules apply to the payment of contributions covered by the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"). Pursuant to Code Section 414(u)(1)(A) and (B), payments made in the applicable USERRA "make-up" period shall not be included in the Code Section 415(c) test for the calendar year in which the payment is made, and shall instead be allocated to the calendar year for which it relates. This rule exists to address a situation in which make up contributions permitted by USERRA for multiple years, in addition to the regular on-going contributions, were all made at once upon the return of a plan member on USERRA-approved leave. If the Code Section 415(c) limits were applied to the sum of these contributions, then a member might exceed the applicable limit.

In SDCERS' case, generally in "real life," the employee is being paid differential pay while on military leave, so their regular deductions for contributions remain as is (on a pre-tax basis). For the few employees who do not receive sufficient pay throughout the period to remain current on contributions, they are given options on how to restore contributions (e.g., lump sum installments). This group may need to be moved to an Exception Management process.

5. **Code Section 414(v).**

Code Section 414(v) provides that an "applicable employer plan" may permit an eligible participant to make additional elective deferrals in any plan year subject to certain limits. An

"applicable employer plan" includes a 401(a) plan, a 403(b) plan, a SEP or a SIMPLE IRA, and a 457(b) plan. An eligible participant means a participant in the plan who will attain age 50 in the plan year and who would otherwise be "capped" out by other Code limitations. These additional elective deferrals may not exceed the lesser of the "applicable dollar amount" (for 2006 and thereafter this amount is $5,000) or the difference between the participant's compensation minus all other elective deferrals. For purposes of applying this limit, all 401(a) plans, 403(b) plans, SEPS and Simple IRAs of a single employer must be aggregated. Multiple 457(b) plans of a single employer must be aggregated, but are not aggregated with the other types of employer plans.

An additional elective deferral under Code Section 414(v) will not be subject to the otherwise applicable limitation under Code Section 401(a)(30), 402(h), 403(b), 408, 415(c), and 457(b) (determined without regard to 457(b)(3)).

Therefore, in determining whether an SDCERS member who makes an after-tax employee contribution is violating the 415(c) limits, the member's 415(c) limit is determined without regard to any additional elective deferral made under Code Section 414(v).

B. DEFINITION OF COMPENSATION

1. General Rule

Code Section 415(c)(3)(A) defines "participant's compensation" as "the compensation of the participant from the employer for the year." Code Section 415(c)(3)(D) includes as compensation elective deferrals under Code Section 402(g)(3) and amounts contributed by the employer at the election of the employee which are excluded from income under Code Sections 125, 132(f)(4), or 457.

Treas. Reg. § 1.415-2(d)(2) provides the following definition of compensation:

> For purposes of applying the limitations of section 415, the term "compensation" includes all of the following:
>
> (i) The employee's wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income ....
>
> ***
>
> (iii) Amounts described in sections 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee.

Code Section 104(a)(1) excludes from gross income amounts received under workmen's compensation acts as compensation for personal injuries or sickness.

2. **Safe Harbor Definitions**

There are at least three safe harbor options available to a plan for purposes of defining compensation for Code Section 415(c):

(1) Define compensation on a person by person basis, including all taxable income and certain items not included on Form W-2, imputed income items, etc. This approach has the advantage of producing the highest possible compensation amount for each individual, but is not administrable for a plan of any size. In order to take this approach, it would be necessary for SDCERS to determine the tax treatment of domestic partner health coverage and various other items.

(2) Define compensation based on the number reported by the employer as gross income in Box 1 of each employee's Form W-2. This approach results in a lower number than method 1, but is much easier to administer.

(3) Define compensation based amounts subject to federal income tax withholding, but excluding taxable reimbursements and the cost of group-term life coverage. This approach also results in a lower number than method 1, but is generally easily available from the employer or payroll service provider and is therefore much easier to administer than an individualized approach.

3. **Treatment of Workers Compensation**

Plans often question how to treat workers compensation payments for purposes of the Code Section 415(c) definition of compensation. Generally, workers compensation payments are excluded from gross income, provided they are paid under a workers compensation statute, and therefore would not be includible as compensation under Code Section 415(c)(3). We believe this is true regardless of whether the employer is funding the payments directly or has paid for worker's compensation insurance, as in either case the amounts paid would (presumably) be paid pursuant to a worker's compensation statute.

There is a special rule under Code Section 415(c)(3)(C) which provides as follows:

(C) SPECIAL RULES FOR PERMANENT AND TOTAL DISABILITY. In the case of a participant in any defined contribution plan—

(i) who is permanently and totally disabled (as defined in section 22(e)(3)),

(ii) who is not a highly compensated employee (within the meaning of section 414(q)), and

(iii) with respect to whom the employer elects, at such time and in such manner as the Secretary may prescribed, to have this subparagraph apply,

the term "participant's compensation" means the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally

disabled. This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this subparagraph are nonforfeitable when made. If a defined contribution plan provides for the continuation of contributions on behalf of all participants described in clause (i) for a fixed or determinable period, this subparagraph shall be applied without regard to clauses (ii) and (iii).

Treas. Reg. § 1.415-3(d)(1)-(3) provides that the voluntary and mandatory employee contributions (but not picked up contributions) under a defined benefit plan are treated as a separate defined contribution plan maintained by the employer, subject to the limitations on contributions of Code Section 415(c) and Treas. Reg. § 1.415-6. Thus, while Code Section 415(c)(3)(C) specifies its applicability to defined contribution plans, it could be argued that these provisions would be applicable to that portion of a defined benefit plan that is to be treated as a defined contribution plan.

There is very little guidance on the application of Code Section 415(c)(3)(C). Treas. Reg. § 1.415-2(d)(9) is reserved for "special rules for permanent and total disability," but no regulations have yet been issued. IRS Notice 83-10, which provided guidance regarding amendments under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), did provide a limited discussion on Code Section 415(c)(3)(C):

> TEFRA amended the definition of compensation to permit a defined contribution plan to include as compensation amounts not actually paid in the case of disabled employees who are not officers, owners, or highly compensated. In such a case, the rate of compensation earned immediately before disability can be imputed for the period of disability. However, any allocations based on this imputed compensation must be nonforfeitable. For example, an employee was compensated at the rate of $10,000 per year. On July 1, 1981, the employee received a raise that increased his salary to $20,000 per year. On December 31, 1981, the employee became permanently and totally disabled. Although the employee only received compensation of $15,000 for 1981, in computing the employee's rate of pay for 1982 the employee is deemed to have compensation at the rate of $20,000 per year.

The Small Business Job Protection Act of 1996 ("SBJPA") added the last sentence of Code Section 415(c)(3)(C) in order to extend its provisions to highly compensated employees, as explained by the Conference Report on the SBJPA:

> **Present law**
>
> Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

House bill

> The House bill provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for continuation of contributions on behalf of all participants who are permanently and totally disabled.

The Conference Report on HR 3448 (August 1, 1996) (emphasis added).

This special rule provides that in the case of an individual with a total and permanent disability, Code Section 415(c) compensation would be deemed to be compensation at the rate the employee was being paid prior to the disability. This then leads to the question of how this provision is applied. It is not clear whether Code Section 415(c)(3)(C) is really designed solely to provide an avenue for an employer to continue to make contributions to a defined contribution plan by imputing to a disabled employee the income that he earned prior to becoming disabled, or instead is definitional for 415 compensation purposes, thereby creating a base for applying the 415(c) limit.

In SDCERS' case, the City has industrial leave paid under the active payroll, with the possibility the person will go to a different payroll (i.e., workers compensation). This may require that a person in this situation be moved to an exception management process.

C. SERVICE PURCHASES

One of our primary areas of concern with regard to 415(c) testing is with respect to service purchases. A voluntary employee after-tax contribution is subject to 415(c) testing unless the more advantageous provisions of Code Section 415(n) apply. As noted in an earlier section of the report, if an employee makes a voluntary contribution for a service purchase, the voluntary contribution may be tested under more generous 415(c) limits or 415(b) limits. The 415(c) limits under 415(n) are as follows:

> For purposes of Code Section 415(n) service purchases, only the dollar limit under Code Section 415(c) applies ($40,000 (adjusted for inflation to $42,000 for 2005; $44,000 for 2006)) by treating all permissive service contributions as an annual addition under that limit.

D. ANALYSIS OF ALL CITY PLANS

Code Section 415(g) requires the aggregation of all plans of an employer for 415 testing purposes. Therefore, our other primary area of concern for 415 testing occurs with respect to the other defined contribution plans that are maintained by the City – the 401(k) plan and the SPSP. The City's 457(b) deferred compensation plan is not aggregated with SDCERS.

VI.
APPLICATION OF CODE SECTION 415(c) TO SDCERS AND RECOMMENDATIONS

A. PLAN DOCUMENT PROVISIONS

SDMC § 24.1010(h) (*per pending amendment*) provides that employee contributions to, and benefits from, SDCERS must comply with the Code Section 415 limitations on contributions and benefits. The provision further establishes the calendar year as the testing year and permits SDCERS to modify contributions as necessary to ensure compliance with Code Section 415. However, the Board Rules do not contain any provisions relating to Code Section 415 compliance, nor do any other policies or documents of which we are aware.

B. TESTING OF "ANNUAL ADDITIONS"

1. Plan Aggregation

Prior to 1/1/06, SDCERS has not tested annual additions against the Code Section 415(c) limitations. The City administers three defined contribution-type plans: the 401(k), SPSP, and a 457(b) plan. The City tests elective deferrals to the 401(k) and 457(b) plans. The City does not conduct Code Section 415(c) testing for its 401(a) plans (401(k), SPSP, and SDCERS). The other City plans and SDCERS are subject to qualification failure if the 415(c) testing requirement is not satisfied and individuals are contributing in excess of the limitations to the plans in the aggregate. In order to address this qualification issue, SDCERS would have to coordinate with City to test for both the dollar and compensation limits under Code Section 415(c). For a limitation year (the calendar year), SDCERS would have to test after-tax employee contributions to SDCERS against the 415(c) limits by first adding the amount of after-tax SDCERS contribution to the total annual contributions (both employee and employer) made to both the 401(k) and the SPSP plans. The resulting total would be tested against the lesser of the $40,000 (as adjusted by the IRS annually) dollar limit or the 100% of compensation issue. In order to perform this test, SDCERS must select a definition of compensation that is permitted under the Code (see next section). The pre-tax (picked-up) contributions to SDCERS would not be used in the 415(c) testing.

If the after-tax contribution was made for a purchase of permissive service credit, Code Section 415(n) would apply and permit a higher level of contribution than under Code Section 415(c).

The Airport and Port only offer a 457(b) plan; they do not provide a 401(k) or 401(a) plan. As a result, 415(c) testing for SDCERS purposes would not require aggregation with the Airport and the Port 457(b) plans.

2. Definition of Compensation

We discussed the three safe harbor definitions of compensation with SDCERS staff. Currently, none of the compensation fields provided by the City in Pension Gold represents any of the safe harbor definitions. SDCERS staff and the City have compared W-2 compensation used by the City with "gross compensation" reported as Gross Salary in Pension Gold. SDCERS

staff has determined that the compensation numbers that are currently provided to SDCERS by the plan sponsors do not comport with any of the three safe harbor definitions. Therefore, for future testing purposes, it was determined that SDCERS would ask the plan sponsors to provide the Medicare wages amount from the W-2 system as a reasonable proxy for the safe harbor that starts with taxable wages and then restores elective deferrals.

Finally, please note that all plans which must be aggregated for purposes of 415(c) testing must use the same definition of compensation for those purposes. Therefore, if the plan sponsors are using a different definition of compensation for purposes of their testing, SDCERS must collaborate with them to arrive at a consistent approach.

C. Conclusions Regarding Retrospective 415(c) Testing

Given the 415(b) testing approach described in earlier sections of this Report, SDCERS is proposing not to do retrospective 415(c) testing. This should be a reasonable approach considering the following factors:

- Since 1987, all mandatory employer contributions have been picked-up and thus would be subject to 415(b) testing.
- Since 1997, all service purchases made with after-tax employer dollars are subject to either modified 415(c) testing or modified 415(b) testing. SDCERS has elected 415(b) testing.
- Service purchases permitted as of August 5, 1997 are grandfathered and thus are not subject to 415(c) testing.
- For retrospective 415(b) testing, SDCERS is not backing out any after-tax employee contributions.
- Service purchases made via rollover and plan-to-plan transfer from the DC plans are not subject to 415(c) testing.
- Service purchases made by plan-to-plan transfers from the 457(b) plan are subject to regular 415(b) testing.

D. Conclusions Regarding Prospective 415(c) Testing

Given the practical problems associated with 415(c) testing, SDCERS has determined to take the following prospective approach starting January 1, 2007. For the 2006 calendar year, a self-correction approach will be followed.

1. Definition of Tested Group

The tested group will consist of all employees making after-tax contributions on and after January 1, 2007.

2. **Testing of Service Purchases Made with After-Tax Employee Contributions**

All service purchases made with after-tax employee contributions will be tested under the modified 415(b) testing under 415(n) if the service being purchased is permissive service, including qualified and nonqualified service, in accordance with the chart above. This means the benefit attributable to these contributions will not be tested under 415(c).

3. **Testing of Other After-Tax Employee Contributions**

Any other after-tax employee contributions received would be tested at the time of receipt on an "exception basis." This means that prior to actually accepting the employee after-tax contributions, SDCERS would contact the City and inform it of the after-tax contributions and run the 415(c) test. If the contributions "passed," they would be accepted. If the contributions failed, they would not be accepted. At the end of the calendar year, those individuals from whom after-tax contributions were accepted would be retested.

4. **USERRA Testing**

In the case of USERRA contributions, the 415(c) limits that would be examined would be the limits in place with respect to the covered service – not necessarily the year of the payment.

5. **Compensation Definition**

SDCERS will request the plan sponsors provide the Medicare wages amount from the W-2 system and use that to test.

6. **Testing Protocol**

The testing protocol for this is set forth in Exhibit D.

7. **Priority**

One issue raised in this context is that of "priority." That is, it is important that a clear priority be established among the different plans as to what will be reduced first, second, etc. in the event that annual additions exceed the Code Section 415(c) limitation. This priority list should include not just the different San Diego defined contribution plans, but also the different types of contributions possible to each of those plans.

- First, attempt the correction through the 401(k) program. The amount of excess contributions would be distributed to the member.

- If the amount of 401(k) contributions for the year is not enough for the correction, then the next plan to consider would be SPSP. However, in order to preserve the plan's status as the Social Security replacement plan, the amount of contributions available to be refunded would be limited to the voluntary contributions.

- If the amount in the SPSP available for refund was insufficient to make the correction, then the correction would have to be made from SDCERS. This could affect the member's service purchase.

E. TESTING OF SERVICE PURCHASES – BY SOURCE

1. SDCERS Provisions

SDMC § 24.1310(a) provides that in order to purchase Creditable Service a member must pay an amount, including interest, determined by the Board before the effective date of retirement. This section goes on to provide as follows:

> (b) Subject to any limitations imposed by the Internal Revenue Code, such payments under section 24.1310(a) may be made by lump sum, installment payments, direct transfer to the Retirement System from any defined contribution plan maintained by the City of San Diego, or in such manner and at such time as the Board may by rule prescribe. Any sums paid by a Member under section 24.1310 are considered to be and administered as Member contributions.

SDMC § 24.1310(b). The Board has adopted rules under this section, which the Board has recently amended to read as follows:

> **Rule 10.50 Methods of Payment.**
>
> (a) Subject to any limitations or conditions imposed by applicable tax laws and regulations, a member may pay for service credit by:
>
> (1) lump sum,
>
> (2) installment payments through payroll deduction,
>
> (3) direct transfer to the Retirement System from any tax qualified defined contribution plan maintained by the City, Airport Authority or Unified Port District,
>
> (4) rollover or direct transfer of funds from an eligible retirement plan,
>
> (5) direct in-service transfer from an IRC 457(b) compensation plan or an IRC 403(b) plan, subject to Board Rule 10.60 (subject to prior approval by the IRS); or
>
> (6) any other source allowable under federal law.
>
> (b) The System will treat all amounts paid by members under this Division as member contributions.

(c) A member must complete all payments to purchase service credit before his or her effective date of retirement, entry into DROP, or termination of employment (in the case of a deferred retirement).

(d) If a member elects to make installment payments:

(1) the member must agree to an installment contract with a payment plan that includes the purchase cost plus installment interest,

(2) the payments must be made through payroll deduction,

(3) the payments must be at least $20 per pay period,

(4) the System will charge installment interest to the member's individual account using the actuarial assumed interest rate in effect at the time the installment contract is executed, and

(5) if making pre-tax payments, the member must complete the installment contract before he or she first becomes eligible to service retire, unless the member acknowledges in writing the negative consequences of failing to do so. (See form SDCERS uses for this. See Exhibit L.)

Board Rule 10.50.

The Board has adopted Rule 10.60 to read as follows:

Rule 10.60 In-Service Transfer of Funds from a 457 Defined Compensation Plan to Purchase Service Credit.

(a) Purchase of Service Credit under General Five-Year Provision (Board Rule 10.10): Before assets may be transferred to SDCERS in-service from a 457 plan to purchase service under Board Rule 10.10 (general five-year purchase), the member must complete and sign a certification of corresponding service. Corresponding service may be any compensated private or public sector service or self-employment, as long as the service has not been credit under any SDCERS plan (City, Airport Authority or Unified Port District). The amount of corresponding service must be equal to or greater than the amount of service credit the member is purchasing. This subsection will become effective upon IRS approval of the certification procedure.

(b) Purchase of "Service-Connected" Service Credit. A member may purchase service-connected service credit under Board Rule 10.00 by an in-service plan-to-plan transfer from a 457(b) plan. No certification of corresponding service is required.

With this new Rule 10.60 in place, subject to IRS prior approval, transfers from the 457 plan will be accepted for service purchases as described in (a) and (b). See PLR 200550042.

The Board Rules also provides for the terms of installment contracts in Board Rule 10.70. Based upon these rules, it is clear that SDCERS has attempted to avail itself of all methods of service purchases.

2. Compliance Testing Chart

The following chart shows how the available sources of voluntary employee contributions for service purchases should be tested under either Code Section 415(c) or 415(n). (Refer to the earlier chart for a categorization of service purchases as permissive service and as qualified and non-qualified service.)

Voluntary Employee Contributions for Service Purchases	**415(c) Testing or 415(n) Testing**
In-service transfers from DC Plans (401(k), SPSP)	415(c) limits (including 415(n) modified limits) do not apply. Regular 415(b) limits should be applied at distribution.
Lump sum after-tax employee contributions and installment contracts for after-tax contributions if for non-permissive service or for nonqualified permissive service credit in excess of limits	415(c) limits apply (lesser of $40,000 (adjusted) or 100% compensation in the year of purchase). These will be tested on an exception basis.
Lump sum after–tax employee contributions and installment contracts for after-tax contributions if for permissive service	415(n) limits apply. Therefore, purchase will be tested under modified 415(b) limits.
Picked-up employee contributions for installment contracts Note: A favorable IRS private letter ruling is the mechanism for obtaining approval for a pick-up of employee contributions for a service purchase.	415(c) limits (including 415(n) modified limits) do not apply. Regular 415(b) limits should be applied at distribution.
Lump sum rollovers from eligible plans (401(a), 457(b), 403(b), 401(k), 403(a) and IRAs)	415(c) limits (including 415(n) modified limits) do not apply. Rollovers only after separation from service except IRAs.
Repayment of refunded contributions	Under 415(c)(3), 415(c) limits will not apply. 415(b) limits will apply at distribution.
Lump sum transfers from 457(b)/403(b) plans	Limited to permissive service credit and restoration of service. 415(c) limits will not apply. 415(b) limits will apply. See Rule 10.60.

It is our understanding from SDCERS staff that the vast majority of service purchases are made by plan-to-plan transfer from the Employers' plans. However, all of the other mechanisms are used to some extent, including after-tax payments.

3. Leave Conversion Contributions

In addition to service purchases, the Municipal Code also provides for leave conversion to Creditable Service:

> (c) Notwithstanding section 24.1310(a), effective July 1, 2002, represented Members in the San Diego Firefighters Local 145 bargaining unit who have not yet entered DROP may convert the cash equivalent of their Unused Annual Leave accrued after July 1, 2002, to Creditable Service in the Retirement System on a pre-tax basis. The amount of the Creditable Service to be credited in the Retirement System will be the amount the Board determines to be the employer and employee cost of that Creditable Service. Represented Members in the Local 145 bargaining unit are not eligible to exercise any cash-out feature of Annual Leave that they accrue after July 1, 2002, including Annual Leave accrued after July 1, 2002, while in DROP.

SDMC § 24.1310(c). This provision provides for a pre-tax conversion of unused annual leave in order to buy service in SDCERS.[7] If these amounts were converted on a pre-tax basis, the benefit attributable to these conversion amounts would be tested under 415(b). Please note: collection of those converted contributions is covered in our Exclusive Benefit Report.

F. Testing of USERRA Service Purchases

SDMC § 24.1309 addresses purchase of retirement credit for service in the armed forces. The provision specifies that for purchases made pursuant to a leave due to military service, the payment is treated as an annual addition for the calendar year to which it relates. In order to provide appropriate treatment of USERRA service purchases, SDCERS will need to work with Employers to determine USERRA eligibility. The problem of accurate USERRA reporting may be limited to only a few SDCERS members because most SDCERS members who are called to military service receive differential pay. It is the City's practice to deduct the member's contribution from the differential pay on a picked-up basis. As a result, most SDCERS members retiring from USERRA-covered service to employment do not need to make any contributions for the USERRA leave period.

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[7] It is our understanding that post July 1, 2002, hours can be converted or used to extend DROP or run out with a terminal leave. On the City side, the hours after July 1, 2002 cannot be cashed out. We further understand the value of these annual leave hours is calculated using the hourly rate calculated on the same basis as the pension salary, then converted to dollars, which dollars are then reconverted to additional time. An example presented was where 500 hours equated to $30,000, which (for that individual) would purchase 1.8472 additional years. The individual can choose how much to convert.

VII.
VOLUNTARY CORRECTION PROGRAM ("VCP") FILING

A. General Approach

As problems were discovered, we worked with SDCERS, Cheiron, and Linea to develop a correction mechanism. As we have previously discussed, the Employee Plans Compliance Resolution System ("EPCRS"), Revenue Procedure 2003-44, provides for a Voluntary Correction Program ("VCP") under which the IRS approves a plan qualification correction through the issuance of a Compliance Statement. The VCP program is governed by a variety of correction principals. One of the key requirements is "full correction":

> Generally, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all taxable years.

Rev. Proc. 2003-44, Section 6.01. However, as noted in the Conclusion Sections above, SDCERS wishes to make a case for a less than full correction based upon the unique facts of the situation. The testing protocols being proposed are all outlined in Sections IV and VI above.

B. Timetable

The VCP would cover the retrospective analysis that covers retirees from 1995 through the end of 2005. SDCERS would then apply self-correction for 2006. Prospective testing would begin in 2007.

Appendix A

Overview of Code Section 415 Proposed Regulations

DEFINED BENEFIT PLANS

- Multiple annuity starting dates. The Proposed Regulations provide new rules for determining the annual benefit under a defined benefit plan when there has been more than one annuity starting date (i.e., where the application of the Code Section 415(b) limit must take into account prior distributions as well as currently commencing distributions). Prop. Reg. § 1.415(b)-2. This would occur when a participant has received one or more distributions in limitation years prior to an increase in the accrued benefit occurring during the current limitation year or prior to the annuity starting date for a distribution that commences during the current limitation year. These rules may also apply when a benefit payment is increased as a result of plan terms applying a cost-of-living adjustment ("COLA") pursuant to an adjustment of the Code Section 415(b) dollar limit, unless the plan provides for application of a safe harbor methodology set forth in the Proposed Regulations for determining the adjusted amount of the benefit (see discussion below under cost-of-living adjustments).

  In the case of multiple annuity starting dates, the annual benefit subject to Code Section 415(b) testing is equal to the sum of the annual straight life equivalent annuity attributable to the following:

  1. the accrued benefit that has not commenced;

  2. the annual benefit determined for any distribution with an annuity starting date that occurs within the current limitation year and on or before the current determination date;

  3. the annual benefit determined for any remaining amounts payable under a distribution with an annuity starting date that commenced in a prior year; and

  4. the annual benefit attributable to prior distributions.

  Prop. Reg. § 1.415(b)-2(a)(3)(i).

  The annual benefit attributable to prior distributions is determined by adjusting the amounts of prior distributions to an actuarially equivalent straight life annuity commencing at the current determination date. The Proposed Regulations apply rules that are analogous to the rules for adjusting other benefits to determine the amount of the actuarially equivalent straight life annuity for purposes of determining the annual benefit attributable to prior distributions. Prop. Reg. § 1.415(b)-2(a)(3)(ii), (b).

  A prior distribution that has been entirely repaid to the plan (with interest) does not give rise to an annual benefit attributable to prior distributions. Prop. Reg. § 1.415(b)-2(a)(3)(iv).

In the case of a new election modifying multiple annuity payments that have already commenced, the payments made before the change plus the modified payments must satisfy the Code Section 415(b) limit in effect on the original annuity starting date, based on the assumptions applicable at that time. However, payment adjustments that reflect cost-of-living increases under Code Section 415(d) are ignored for this purpose.

- Note: The specific rules on the application of testing of multiple annuity starting dates are very complex. Ice Miller's comment letter focused on this area as a primary cause for concern and urges the Service to take a simpler approach to testing in this area. We believe the multiple annuity starting date proposed rules could impact a variety of common governmental plan features – ad hoc COLAs, 13th checks, DROPs, PLSOs, and plan amendments. We also think it also provides a difficult interaction with Code Section 401(a)(9) compliance.

- **Cost-of-living adjustments**.

  - IRS Limit Adjustments. The Proposed Regulations provide rules regarding application of the cost-of-living adjustments to the Code Section 415 limits. Prop. Reg. § 1.415(d)-1. The Regulations specify the circumstances under which an adjusted limit is permitted to be applied to participants who have previously commenced receiving benefits under a defined benefit plan. The adjusted limit would be applicable to current employees who are participants in a defined benefit plan and to former employees who have retired or otherwise terminated service and have a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive benefits. A plan may provide that the annual increase applies for a participant who has previously commenced receiving benefits only to the extent that benefits have not been paid, and a plan must specifically so provide in order for the increase to be effective. Prop. Reg. § 1.415(a)-1(d)(3)(v)(C).

    The Proposed Regulations provide a safe harbor under which the annual benefit will satisfy the limitations of Code Section 415(b) for the current limitation year following an adjustment to benefit payments that is made to reflect the IRS cost-of-living adjustment made under Code Section 415(d). If such adjustments are made in accordance with this safe harbor, the multiple annuity starting date rules will not apply with respect to such adjustment.

    An adjustment to a benefit for a COLA increase under Code Section 415(d) will be treated as being made under the safe harbor if (1) the participant has received one or more distributions that satisfy the requirements of Code Section 415(b) before the date the increase to the applicable limit is effective; (2) the adjusted distribution is solely as a result of an increase in the Code Section 415(d) limits; and (3) the amount payable to the employee for the limitation year and subsequent limitation years is not greater than the amounts that would otherwise be payable without regard to the adjustment, multiplied by a fraction, the numerator of which is the limitation under Code Section 415(b) in effect for the distribution following the Code Section 415(d) increase, and the denominator of which is such limitation

under Code Section 415(b) in effect for the distribution immediately before the increase. Prop. Reg. § 1.415(d)-1(a)(5).

- Plan Benefits with Fixed COLAs. Last year the IRS issued PLR 200452039, which provided that a plan benefit with an automatic COLA had to take into account the value of the COLA when testing the benefit under the Code Section 415(b) limit. Under the Proposed Regulations, there is an example under which the plan had to reduce the benefit limit to recognize the value of any automatic, fixed COLAs provided under the plan. Prop. Reg. § 1.415(b)-1(c)(5), Example 6.

- **Benefit tested under 415(b)**. The Proposed Regulations prohibit both the payment and accrual of a benefit in excess of the Code Section 415(b) limits. Prop. Reg. § 1.415(b)-1(a)(1) (3). In the past, this Code Section has generally been interpreted for governmental plans as requiring that benefits paid, not just accrued, must meet the 415(b) limit.

  - Note: Our comment letter to the Service raises the problems with this issue, including an overarching concern with the focus of the Proposed Regulations on the accrual concept versus the benefit payment concept, noting the inherent difficulties this would present for governmental plans. We really think this is the "heart" of the problem with the Proposed Regulations. Without a different reference point (at least for governmental plans), compliance will be very problematic.

- **Dollar limit applicable to early or late retirement**. Code Section 415(b)(2)(C) provides that the dollar limit must be actuarially reduced when benefits begin before age 62. The Proposed Regulations generally use the plan's determinations for actuarial equivalence of early retirement benefits, but override them when the use of the specified statutory assumptions results in a lower limit. Prop. Reg. § 1.415(b)-1(d).

  If the benefit is not forfeited at the member's death, there is no adjustment to the dollar limit with respect to mortality to reflect the probability of the member's death between the annuity starting date and age 62 (which results in a higher dollar limit than if mortality were considered). The Proposed Regulations allow a plan to treat a benefit as not being forfeited if the plan does not charge members for providing a qualified pre-retirement survivor annuity, but only if the plan applies this treatment for adjustments before age 62 and after age 65. Prop. Reg. § 1.415(b)-1(d)(2).

  Pursuant to Code Section 415(b)(2)(I), the dollar limit is not adjusted for commencement before age 62 for a distribution from a governmental plan on account of the participant becoming disabled by reason of personal injuries or sickness, or as a result of the death of the participant. Prop. Reg. § 1.415(b)-1(d)(4). Similarly, the less than ten years of participation reduction does not apply to such benefits. Prop. Reg. § 1.415(b)-1(g)(3).

  The Proposed Regulations similarly provide for the dollar limit to be actuarially increased for benefits that begin after age 65. However, if the plan does not actuarially increase benefits in the case of later retirement age, the dollar limit adjustment is not permitted.

Prop. Reg. §§ 1.415(a)-1(d)(3)(v)(C); 1.415(b)-1(e). A National Council on Teacher Retirement representative testified on this point at the August 17 hearing, urging the Service to reconsider this approach.

- **Conversion of benefits to straight life annuity**. The Proposed Regulations provide rules under which a retirement benefit payable in any form other than a straight life annuity (or qualified joint and survivor annuity ("QJSA")) is converted to the straight life annuity that is actuarially equivalent to that other form to determine the annual benefit used to show compliance with Code Section 415 for that form of distribution. The Proposed Regulations reflect statutory changes that specify the actuarial assumptions to be used for these equivalency calculations. Prop. Reg. § 1.415(b)-1(c).

  For a form of benefit that is not subject to the minimum present value rules of Code Section 417(e) (which includes any governmental plan benefits), the straight life annuity payable under the plan at the member' current age (not the straight life actuarial equivalent of the selected benefit form using the plan's actuarial assumptions) is compared to the straight life annuity that is the actuarial equivalent of the optional form of benefit, determined using specified statutory assumptions, and the larger of the two straight life annuities is used as the annual benefit subject to 415 testing. Prop. Reg. § 1.415(b)-1(c)(2).

  - Note: Ice Miller's comment letter addresses the issue of the appropriate actuarial assumptions that should be used for this conversion.

- **Benefit forms for which no adjustment is required**. The survivor portion of a benefit that is a QJSA is not taken into account in determining the annual benefit subject to 415(b) testing. The Proposed Regulations provide that this exception will apply to any portion of a benefit that is paid as a QJSA, even if another portion of the benefit is paid in some other form (for example, a partial lump sum). Prop. Reg. § 1.415(b)-1(c)(4)(i)(A), (ii)(B).

  Further, ancillary benefits not directly related to retirement benefits are not taken into account for purposes of Code Section 415(b) testing. Prop. Reg. § 1.415(b)-1(c)(4)(i)(B).

- **Exclusion of annual benefit attributable to mandatory after-tax employee contributions**. The Proposed Regulations retain the rules under the existing regulations that the annual benefit does not include the annual benefit attributable to mandatory employee contributions (which are not picked-up). Prop. Reg. § 1.415(b)-1(b)(1)(ii).

  The Regulations provide that the annual benefit attributable to mandatory employee contributions is determined using the factors described in Code Section 411(c)(2)(B) and (C) and the regulations thereunder, regardless of whether Code Section 411 applies to the plan (which such Section does not apply to a governmental plan). Prop. Reg. § 1.415(b)-1(b)(2)(iii). Mandatory employee contributions (which are not picked-up) are treated as annual additions to a defined contribution plan for purposed of Code Section 415(c). Prop. Reg. § 1.415(c)-1(a)(2)(ii)(B) and (b)(3). Picked-up employee contributions are

treated as employer contributions to a defined benefit plan. Prop. Reg. § 1.415(b)-1(b)(2)(ii)(A).

- ➢ Note: In our comment letter to the Service, we have raised our concerns with the difficulties in applying the Code Section 411 methodology in the governmental plan context.

The Proposed Regulations provide that, if voluntary employee contributions are made to a plan, the portion of the plan to which such contributions are made is treated as a defined contribution plan under Code Section 414(k), not a defined benefit plan, and is not taken into account in determining the annual benefit under the portion of the plan that is a defined benefit plan. Prop. Reg. § 1.415(b)-1(b)(2)(iv).

The Proposed Regulations would clarify that picked-up contributions, loan repayments, the repayment of any amount previously distributed, and the repayment of withdrawn employee contributions, would not be treated as employee contributions. Prop. Reg. § 1.415(b)-1(b)(2)(ii).

The Proposed Regulations also provide that, in determining the amount of the annual benefit that is excluded from testing because it is funded by employee contributions, member repayments of withdrawn contributions, even if paid after-tax (and thus counted as basis) would not be treated as employee contributions.

- ➢ Note: This treatment does not seem consistent with Code Section 415(k)(3), which provides that repayments of previously withdrawn contributions, plus interest, are not subject to the Code Section 415 limits. Ice Miller's comment letter has raised this issue with the Service.

- **Exclusion of annual benefit attributable to rollovers**. The Proposed Regulations clarify that the annual benefit subject to Code Section 415(b) testing does not include the annual benefit attributable to rollover contributions made to a defined benefit plan (i.e., rollover contributions that are not maintained in a separate account that is treated as a separate defined contribution plan under Code Section 414(k)). Prop. Reg. § 1.415(b)-1(b)(1)(ii). In this situation, the annual benefit attributable to the rollover contributions is determined by applying the rules of Code Section 411(c), treating the rollover contributions as employee contributions, regardless of whether Section 411 applies to the plan. The Proposed Regulations specify that if a plan uses more favorable factors than those specified in Code Section 411(c) to determine the amount of annuity payments arising from a rollover contribution, the annual benefit under the plan would reflect the excess of those annuity payments over the amount that would be specified in Code Section 411(c). Prop. Reg. § 1.415(b)-1(b)(2)(v).

  - ➢ Note: This is an area upon which we have commented to the Service, arguing that the Code Section 411 rules, which are not generally applicable to governmental plans, should not be used in these circumstances; rather, we have proposed that public plans be permitted to use the plan actuarial factors in this

circumstance. We have also asked the Service to provide an example of a defined benefit plan to a defined benefit plan rollover.

- **Treatment of benefits transferred among plans**. Under the current Code Section 415 Regulations, if a transfer is from one qualified plan to another qualified plan, the annual benefit attributable to the transferred assets is not taken into account by the transferee plan. Treas. Reg. § 1.415-3(b)(1)(iv). Further, a transfer from one qualified plan to another qualified plan is not an annual addition in the year of the transfer. Treas. Reg. § 1.415-6(b)(2)(iv).

  The Proposed Regulations attempt to provide further detail on the treatment of transfers between qualified plans, presumably to address concerns by the Service that funds are being transferred between plans without ever ultimately being tested in some fashion under Code Section 415. The Proposed Regulations view transfers on a defined benefit plan to defined benefit plan and defined contribution plan to defined contribution plan basis. The Proposed Regulations would modify the rules of the existing Final Regulations for determining the amount of transferred benefits that are excluded from the annual benefit under a defined benefit plan in the event of a transfer from another defined benefit plan. Prop. Reg. § 1.415(b)-1(b)(3).

  In the case of transfers between defined benefit plans subject to the plan aggregation rules (i.e., the annual benefit under both plans must be combined for purposes of Code Section 415 testing), the transferred benefits are included in determining the annual benefit under the plan receiving the transfer (the transferee plan) and are disregarded in determining the annual benefit under the transferring plan (the transferor plan). Thus, under each plan, the annual benefit is determined taking into account the actual benefits provided under that plan after the transfer. Prop. Reg. § 1.415(b)-1(b)(3)(A).

  In the case of transfers between non-aggregated defined benefit plans, the benefits associated with the transferred liabilities (other than surplus assets) are treated by the transferor plan as a single sum distribution (which presumably is tested under the Code Section 415(b) limit). Although such a transfer is treated as a distribution in computing the annual benefit under the transferor plan, no corresponding adjustment to the annual benefit under the transferee plan is made to reflect the fact that some of the benefits provided under the transferee plan are attributable to the transfer. Thus, the actual benefit provided under the transferee plan is used to test the annual benefit under the transferee plan, even thought the transferred amount is included as a distribution in determining the annual benefit under the transferor plan. Prop. Reg. § 1.415(b)-1(b)(3)(B).

  In the case of transfers between defined contributions plans, the transfer is not treated as an annual addition.

  Thus, transfers between defined benefit and defined contribution plans are not specifically addressed under the Proposed Regulations; in particular, the difficult issue is a transfer from a defined benefit to a defined contribution plan. Hopefully, the Final Regulations will provide some clarity to this issue.

- **Application of $10,000 exception**. The benefits payable to a participant will satisfy Code Section 415(b) if the benefits payable to that participant under the plan and all other defined benefit plans of the participant do not exceed $10,000 for the plan year or for any prior plan year, and the employer has not at any time maintained a defined contribution plan in which the participant participated. Thus, for example, a distribution for a limitation year that exceeds $10,000 will not fall in this exception, even if it is a single-sum distribution that is the actuarial equivalent of an accrued benefit with annual payments that are less than $10,000. Prop. Reg. § 1.415(b)-1(f).

- **Less than 10 years of participation**. The dollar limit is reduced pro-rata if a participant has fewer than 10 years of participation in the plan. This reduction does not apply to a distribution of survivor or disability benefits from a governmental plan. Prop. Reg. § 1.415(b)-1(g).

- **QDRO payments**. For purposes of Code Section 415, benefits provided to an alternate payee under a QDRO are treated as if provided to the member. Prop. Reg. § 1.415(a)-1(f)(5).

DEFINED CONTRIBUTION PLANS

- **Timing of contributions**. The Proposed Regulations would modify the deadline for making employer contributions to a plan that are credited to a participant's account for a limitation year for purposes of Code Section 415(c). Under the Proposed Regulations, the deadline for a tax-exempt employer to make a contribution to the plan that is credited to a participant's account for a limitation year for purposes of Code Section 415(c) is the 15th day of the tenth calendar month following the close of the taxable year with or within which the particular limitation year ends. Prop. Reg. § 1.415(c)-1(b)(6)(B).

  - **Note**: This is an extension from the earlier deadline now applicable under the existing regulations (the 15th day of the sixth calendar month following the close of the taxable year with or within which the particular limitation year ends).

  As under the current Regulations, employee contributions may not be included in a limitation year unless they are actually made to the plan within 30 days after the close of the limitation year. Prop. Reg. § 1.415(c)-1(b)(6)(C).

  The Proposed Regulations also confirm that employer make-up contributions made pursuant to USERRA, resulting from qualified military service, are not treated as an annual addition for the year in which the contribution is made, but are treated as an annual addition for the year to which the contribution relates. Prop. Reg. § 1.415(c)-1(b)(6)(ii)(D).

- **Definition of "Compensation"**. The Proposed Regulations primarily reflect several statutory changes that were made to Code Section 415(c)(3) since the issuance of the existing Final Regulations. Among these changes are the inclusion in compensation of certain deemed amounts for disabled participants and nontaxable elective amounts for deferrals under Code Sections 401(k), 403(b), and 457, cafeteria plan elections under

Section 125, and qualified transportation fringe benefit elections under Code Section 132(f)(4). Prop. Reg. § 1.415(c)-2.

The Proposed Regulations also permit a plan to use a safe harbor definition of compensation, including Form W-2 wages or wages subject to income tax withholding. Prop. Reg. § 1.415(c)-2(d).

The Proposed Regulations also provide that the definition of compensation is subject to the Code Section 401(a)(17) limits, which is a departure from the generally accepted understanding of this rule. However, because governmental plans are not subject to the 100% of compensation limit under Code Section 415(b), this issue has little practical significance for public plans.

- **Compensation after severance from employment**. The Proposed Regulations provide specific rules regarding when amounts received following a severance from employment may be included as compensation for purposes of Code Section 415. Unlike the other provisions of the Proposed Regulations (which may not be relied upon until the Final Regulations are issued), these changes may be considered effective immediately for limitation years beginning on or after January 1, 2005. Prop. Reg. § 1.415(c)-2(e).

  Generally, the Proposed Regulations provide that amounts received after severance from employment are not considered compensation under Code Section 415, except for the following:

  - If made within 2½ months after a severance from employment, payments (such as regular compensation, overtime, bonuses, etc.) that would have been payable if employment had not terminated, and payments with regard to accumulated leave time that would have been available for use if employment had not terminated, may be included as compensation under Code Section 415. This exception would not include pure severance pay.

  Military differential pay, i.e., pay from an employer to an employee who is in qualified military service, may be included as compensation for purposes of Code Section 415.

  - ➢ **Note**: It is not clear from the Proposed Regulations how payments of regular salary which are made more than 2½ months after severance from employment would be treated. Ice Miller's comment letter asks the Service to clarify this issue.

- **Annual additions subject to Code Section 415(c)**. The Proposed Regulations clarify the definition of "annual additions" which are subject to Code Section 415(c) testing, which include employer contributions, employee contributions, and forfeitures. Prop. Reg. § 1.415(c)-1(b). Additionally, contributions to individual medical accounts that are part of a pension plan under Code Section 401(h) are treated as annual additions to a defined contribution plan (but such contributions are only subject to the dollar limit of Code § 415(c)). Prop. Reg. § 1.415(c)-1(a)(2)(ii)(C), (e). Annual additions do not

include rollovers, repayments under Code Section 415(k)(3), or transfers from another defined contribution plan. Prop. Reg. § 1.415(c)-1(b)(1)(iii). (b)(3).

- **Limitation year**. The Proposed Regulations set forth rules regarding the limitation year that generally correspond to the rules under the existing Regulations, and also provide specific guidelines with respect to overlapping limitation years for aggregated plans. Prop. Reg. § 1.415(j)-1.

  Where defined contribution plans with different limitation years are aggregated, Code Section 415(c) must be applied with respect to each limitation year of each such plan. For each such limitation year, Code Section 415(c) is applied to annual additions that are made for that time period with respect to the participant under all aggregated plans. Similarly, where defined benefit plans with different limitation years are aggregated, the rules of Code Section 415(b) must be applied with respect to each limitation year of each such plan. Thus, the dollar limit of Code Section 415(b)(1)(A) applicable for the limitation year for each plan must be applied to annual benefits under all aggregated plans to determine whether the plan satisfies the requirements of Code Section 415(b).

RULES OF GENERAL APPLICABILITY

- **Combining and aggregating plans**. Under Code Section 415(f) and the Proposed Regulations, all defined benefit plans of an employer are treated as one defined benefit plan, and all defined contribution plans of an employer are treated as one defined contribution plan. Prop. Reg. § 1.415(f)-1.

- **No specific guidance under Sections 415(n) or 415(m)**. The IRS did not issue guidance with respect to the permissive service credit rules under Code Section 415(n) or qualified excess benefit arrangements ("QEBAs") under Code Section 415(m), but did ask for comments regarding the need for guidance on these provisions. In our comments to the IRS we did not request guidance on these statutory sections but did offer our observations on a few key issues in the event that the IRS does issue guidance.

INDEX OF EXHIBITS

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM --
PRESERVATION OF BENEFIT PLAN AND TRUST

EMPLOYER: CITY OF SAN DIEGO, CALIFORNIA

Effective January 1, 2007

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM
PRESERVATION OF BENEFIT PLAN AND TRUST

ARTICLE I.

ESTABLISHMENT OF PLAN AND TRUST

1.01. Establishment Of Plan and Trust. The "San Diego City Employees' Retirement System Preservation of Benefit Plan and Trust" ("this Plan") was established effective as of April 18, 2001.

1.02. Purpose. The purpose of this Plan is solely to provide the part of a Participant's Retirement Benefit that would otherwise have been payable by the San Diego City Employees' Retirement System ("SDCERS") from the Employer's qualified plan, except for the limitations of Code Section 415(b). This Plan is intended to be a "qualified governmental excess benefit arrangement" within the meaning of Code Section 415(m)(3) and must be interpreted and construed consistently with that intent. This Plan is deemed a portion of the Employer's qualified plan solely to the extent required under, and within the meaning of, Code Section 415(m)(3) and Article IX of the San Diego City Charter.

This Plan is an "exempt governmental deferred compensation plan" described in Code Section 3121(v)(3). Code Sections 83, 402(b), 457(a) and 457(f)(1) do not apply to this Plan. With respect to Code Section 457(a), the maximum amount that may be deferred under this Plan on behalf of any Participant for the taxable year may exceed both the amount in Code Section 457(b)(2) (as adjusted for cost of living increases) and the percent of the participant's includable compensation referred to in that Code Section. SDCERS will not hold any assets or income under this Plan in trust for the exclusive benefit of participants or their beneficiaries.

ARTICLE II.

DEFINITIONS AND CONSTRUCTIONS

2.01. Definitions. When the initial letter of a word or phrase is capitalized herein, it has the same meaning as defined below:

(a) "**Actuary**" means the actuary selected by the Board from time to time.

(b) "**Administrator**" means SDCERS and includes any person with whom SDCERS contracts to provide services to the Plan.

(c) "**Airport Retirement Plan**" means the San Diego City Employees' Retirement System First Amended Retirement Plan for Airport Authority Employees as administered under the First Amended Agreement to Administer Retirement Plan between San Diego City Employees' Retirement System and San Diego County Regional Airport Authority, or a subsequent retirement plan established by the Airport.

(d) "**Beneficiary**" means an individual receiving joint and survivor benefits from SDCERS.

(e) "**Board**" means the Board of Administration of SDCERS established under Section 144 of the San Diego City Charter.

(f) "**City**" means the City of San Diego, California.

(g) "**Code**" means the Internal Revenue Code of 1986, as amended, as applicable to a governmental plan, or corresponding provisions of any subsequent federal income tax law.

(h) "**Employer**" means the City.

(i) "**Excess Benefit**" means the benefit determined in accordance with Section 4.01 of this Plan.

(j) "**Participant**" means a Retiree or Beneficiary who is entitled to benefits under this Plan.

(k) "**Plan**" means the "San Diego City Employees' Retirement System Preservation of Benefit Plan" established pursuant to Section 24.1601 through 24.1608 of the San Diego Municipal Code.

(l) "**Plan Year**" means the calendar year.

(m) "**Port Retirement Plan**" means the San Diego City Employees' Retirement System Retirement Plan for San Diego Unified Port District Employees as administered under the First Amended Agreement to Administer Retirement Plan between San Diego City Employees' Retirement System and San Diego Unified Port District, or a subsequent retirement plan established by the Port.

(n) "**Retiree**" means a former member of SDCERS who is receiving a Retirement Benefit from SDCERS.

(o) "**Retirement Administrator**" means the SDCERS Retirement Administrator who is appointed by the Board under Board Rule 4.00.

(p) "**Retirement Benefit**" means the amount of retirement income payable to a Retiree of SDCERS, or the benefit payable to a Beneficiary, without regard to any limitations on that retirement income or benefit under Code Section 415(b).

(q) "**Retirement Fund**" means the special fund established by Section 145 of the San Diego City Charter.

(r) "**SDCERS**" means the San Diego City Employees' Retirement System.

(s) "**State**" means the State of California.

(t) "**Trust Fund**" means the trust fund established pursuant to City Ordinance 0-18930, March 19, 2001 and Article VI of this Plan, which fund constitutes a valid trust under the law of the State.

(u) "Trustees" mean the members of the Board.

2.02. Construction.

(a) Words used in this Plan in the masculine gender include the feminine gender where appropriate, and words used in this Plan in the singular or plural include the plural or singular where appropriate.

(b) Whenever any actuarial present value or actuarial equivalency is to be determined under the Plan to establish a benefit, it will be based on reasonable actuarial assumptions approved by the Board in its sole discretion, and will be determined in a uniform manner for all similarly situated Participants.

ARTICLE III.

PARTICIPATION

All Retirees and Beneficiaries of SDCERS are eligible to participate in this Plan if their Retirement Benefits from SDCERS for a Plan Year are or have been since April 18, 2001, limited by Code Section 415(b). The Board determines for each Plan Year which Retirees and Beneficiaries are eligible to participate in the Plan. Participation in the Plan begins each Plan Year once a Retiree or Beneficiary has an Excess Benefit in that Plan Year. Participation in the Plan ends for any portion of a Plan Year in which the Retirement Benefit of a Retiree or Beneficiary is not limited by Code Section 415(b) or when all benefit obligations under the Plan to the Retiree or Beneficiary have been satisfied.

ARTICLE IV.

PAYMENT OF BENEFITS

4.01. Benefit Amount.

(a) A Participant in the Plan will receive a benefit equal to the amount of retirement income that would have been payable to, or with respect to, a Participant by SDCERS that could

not be paid because of the application of the limitations on his retirement income under Code Section 415(b). An Excess Benefit under the Plan will be paid only if and to the extent the Participant is receiving Retirement Benefits from the Retirement Fund.

(b) Where the Administrator pays a blended benefit to a Participant pursuant to Section 0400 of the Port Retirement Plan or Section 0400 of the Airport Retirement Plan, the Excess Benefit payable from this Plan under Section 4.01 will be an amount bearing the same proportion to the total Excess Benefit payable under all plans administered by the Administrator as the Participant's years of service credit with the City bear to the Participant's total years of service credit with all employers sponsoring plans administered by the Administrator.

4.02. Time for Payment; Form of Benefit. The Excess Benefit will be paid at the same time and in the same manner as the Retirement Benefit payable under SDCERS, and the timing of the Excess Benefit must take into account the existence of monthly deductions from the Retirement Benefit. No election is provided at any time to the Participant, directly or indirectly, to defer compensation under this Plan.

ARTICLE V.

CONTRIBUTIONS AND FUNDING

5.01. Funding. The Plan is, and will remain, unfunded and the rights, if any, of any person to any benefits under the Plan are limited to those specified in the Plan. The Plan constitutes a mere unsecured promise by the Employer to make benefit payments in the future.

5.02. Contributions.

(a) The Board will determine the amount necessary to pay the Excess Benefit under the Plan for each Plan Year. The Retirement Administrator will provide an estimate of the Excess Benefit to the Employer on or before February 28 of each year. The required contribution will be the aggregate of the Excess Benefits payable to all Participants for the Plan

Year and an amount determined by the Board to be a necessary and reasonable expense of administering the Plan. The Employer will contribute the amount the Board determines, from time to time, to be necessary to pay the Excess Benefit of the Participant and administrative expenses of the Plan, and these payments will be made before the Employer deposits are credited to the Retirement Fund. The Employer's required contribution will be due no later than July 1 of each year; provided, however, that the Board may establish an earlier due date with respect to contributions necessary to fund the Excess Benefit of any Participant who will exceed the Code Section 415(b) limitations prior to July 1 of that year. Under no circumstances will Employer contributions to fund the Excess Benefits be credited to the Retirement Fund. Any contributions not used to pay the Excess Benefit for a current Plan Year, together with any income accruing to the Trust Fund, will be used to pay the administrative expenses of the Plan for the Plan Year. Any contributions not used to pay the Excess Benefit for the current Plan Year that remain after paying administrative expenses of the Plan for the Plan Year will be used to fund administrative expenses or benefits of Participants in future Plan Years.

(b) If a Participant is employed by more than one employer at the time of the Participant's retirement, the Administrator will determine the appropriate amount of contributions to be paid by each employer to fund the Excess Benefit, and the Excess Benefits will also be paid from the Employer's separate Plans accordingly.

(c) SDCERS will account separately for the amounts the Board determines to be necessary to provide the Excess Benefit under the Plan for each Participant. But, this separate accounting will not be deemed to set aside these amounts for the benefit of a Participant. Benefits under this Plan will be paid from the Trust Fund.

(d) The consultants, independent auditors, attorneys, and actuaries performing services for SDCERS may also perform services for this Plan; but, any fees attributable to services performed with respect to this Plan will be payable solely by the Employer or from the Trust Fund.

ARTICLE VI.

TRUST FUND

6.01. Establishment of Trust Fund. An "Excess Benefit Trust Fund" (the "Trust Fund") was established pursuant to City Ordinance 0-18930, March 19, 2001, separate from the Retirement Fund, to hold contributions of the Employer. Contributions to this Trust Fund will be held separate and apart from the funds comprising the Retirement Fund and will not be commingled with assets of the Retirement Fund, and must be accounted for separately.

6.02. Trust Fund Purpose. The Trust Fund is maintained solely to provide benefits under a qualified governmental excess benefit arrangement within the meaning of Code Section 415(m), and pay administrative expenses of this arrangement.

6.03. Trust Fund Assets. All assets held by the Trust Fund to assist in meeting the Employer's obligations under the Plan, including all amounts of Employer contributions made under the Plan, all property and rights acquired or purchased with these amounts and all income attributable to these amounts, will be held separate and apart from other funds of the Employer and will be used exclusively for the uses and purposes of Participants and general creditors as set forth in this Plan. Participants have no preferred claim on, or any beneficial interest in, any assets of the Trust Fund. Any rights created under the Plan are unsecured contractual rights of Participants against the Employer. Any assets held by the Trust Fund are subject to the claims of the Employer's general creditors under federal and state law in the event of insolvency.

6.04. **Grantor Trust.** The Trust Fund is intended to be a grantor trust, of which the Employer is the grantor, within the meaning of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code, and will be construed accordingly. This provision will not be construed to create an irrevocable trust of any kind.

6.05. **Trust Fund Income.** Income accruing to the Trust Fund under the Plan constitutes income derived from the exercise of an essential governmental function upon which the Trust is exempt from tax under Code Section 115, as well as Code Section 415(m)(1).

ARTICLE VII.

ADMINISTRATION

7.01. **Administrative Authority.** The Board has the exclusive authority to control and manage the operation and administration of the Plan. The Board has the same rights, duties and responsibilities respecting the Plan as it has with respect to the Retirement Fund pursuant to Section 24.1605 of the San Diego Municipal Code. The Administrator has the same duties and authority respecting the Plan as the Administrator has with respect to the Retirement Fund.

(a) The Board has the power and authority (including discretion with respect to the exercise of that power and authority) necessary, advisable, desirable or convenient to enable it:

(1) to establish procedures to administer the Plan not inconsistent with the Plan and the Code, and to amend or rescind these procedures;

(2) to determine, consistent with the Plan, applicable law, rules or regulations, all questions of law or fact that may arise as to eligibility for participation in the Plan and eligibility for distribution of benefits from the Plan, and the status of any person claiming benefits under the Plan;

(3) to make payments from the Trust Fund to Participants pursuant to Article IV of the Plan,

(4) to contract with a third party to perform designated administrative services under this Plan;

(5) to construe and interpret the Plan as to administrative issues and to correct any defect, supply any omission or reconcile any inconsistency in the Plan with respect to same, subject to and consistent with the Code.

(b) Any action by the Board that is not found to be an abuse of discretion will be final, conclusive and binding on all individuals affected thereby. The Board may take any such action in such manner and to such extent as the Board in its sole discretion may deem expedient, and the Board will be the sole and final judge of such expediency.

(c) The Board may delegate any of its authority to the Administrator with respect to the Trust Fund.

(d) The Board will seek appropriate rulings from the Internal Revenue Service with regard to the status of the Plan under the Code.

7.02. Advice. The Board may employ one or more persons to render advice with regard to its responsibilities under the Plan.

7.03. Payment of Benefits. If in doubt concerning the correctness of their action in making a payment of a benefit, the Board may suspend payment until satisfied as to the correctness of the payment or the person to receive the payment.

7.04. Delegation by Administrator. The Administrator will handle the day-to-day operation of the Plan and may delegate certain functions to a third party.

ARTICLE VIII.

PLAN AMENDMENTS

The Board from time to time may amend, suspend, or terminate any or all of the provisions of this Plan as may be necessary to comply with Code Section 415(m) and to maintain the Plan's or the Retirement Fund's qualified status under the Code.

ARTICLE IX.

NONASSIGNABILITY AND EXEMPTION FROM TAXATION AND EXECUTION

The interests of Participants under this Plan are exempt from any state, county, municipal or local tax, and are not subject to execution, garnishment, attachment, or any other process of law whatsoever, and are unassignable and nontransferable, except as otherwise provided by Section 24.1604 of the San Diego Municipal Code.

ARTICLE X.

MISCELLANEOUS

10.01. Federal and State Taxes. The Board, the Employer, and the Administrator, if any, do not guarantee that any particular Federal or State income, payroll, or other tax consequence will occur because of participation in this Plan.

10.02. Investment. The Board may hold a portion of the Plan uninvested as it deems advisable for making distributions under the Plan, or may invest assets of the Plan pending the Excess Benefit payments in short-term investment grade instruments as otherwise permitted by law.

10.03. Conflicts. In resolving any conflict between provisions of the Plan, and in resolving any other uncertainty as to the meaning or intention of any provision of the Plan, the prevailing interpretation will be the one that (i) causes the Plan to constitute a qualified governmental excess benefit arrangement under the provisions of Code Section 415(m) and the

Trust Fund to be exempt from tax under Code Sections 115 and 415(m), (ii) causes the Plan and SDCERS to comply with all applicable requirements of the Code, and (iii) causes the Plan and SDCERS to comply with all applicable State and City laws.

10.04. Limitation on Rights. Neither the establishment or maintenance of the Plan, nor any amendment to the Plan, nor any act or omission under the Plan (or resulting from the operation of the Plan) may be construed:

(a) as conferring upon any Participant or any other person a right or claim against the Board, Trustees, Employer, or Administrator, if any, except to the extent that the right or claim is specifically expressed and provided in the Plan;

(b) as creating any responsibility or liability of the Employer for the validity or effect of the Plan;

(c) as a contract between the Employer and any Participant or other person;

(d) as being consideration for, or an inducement or condition of, employment of any Participant or other person, or as affecting or restricting in any manner or to any extent whatsoever the rights or obligations of the Employer or any Participant or other person to continue or terminate the employment relationship at any time; or

(e) as giving any Participant the right to be retained in the Employer's service or to interfere with the Employer's right to discharge any Participant or other person at any time.

10.05. Erroneous Payments. Any benefit payment that should not have been made, according to the terms of the Plan and the benefits provided hereunder, may be recovered as provided by law.

10.06. Release. Any payment to any Participant will, to the extent thereof, be in full satisfaction of the Participant's claim being paid thereby, and the Board may condition the

payment on the delivery by the Participant of the duly executed receipt and release in a form determined by the Board.

10.07. Liability. The Board, Trustees, or Administrator, if any, will not incur any liability in acting upon any paper or document or electronic transmission believed by the Board, Trustees, or Administrator to be genuine or to be executed or sent by an authorized person.

The Plan will hold harmless and indemnify the Board, the Trustees, and the Administrator, and the officers and employees thereof, from financial loss arising out of any claim, demand, suit or judgment by reason of alleged negligence or other act by that board member, trustee, officer or employee, provided that the board member, trustee, officer or employee at the time of the alleged negligence or act was acting in the discharge of his duties and within the scope of his employment and that the damages did not result from a willful and wrongful act of gross negligence of the board member, trustee, officer or employee, and provided further that the board member, trustee, officer or employee will, within five days of the time he is served with any summons, complaint, process, notice, demand or pleading, deliver the original or a copy thereof to the Administrator's legal advisor.

The Board may obtain insurance to provide coverage for any liabilities that may arise as described by this Section.

10.08. Governing Laws. The San Diego Municipal Code and the laws of the City and the State of California apply in determining the construction and validity of this Plan.

10.09. Necessary Parties to Disputes. The only party necessary to any accounting, litigation or other proceedings relating to the Plan is the Administrator. The settlement or judgment in any case in which the Administrator is duly served will be binding upon all affected

Participants in the Plan, their beneficiaries, estates and upon all persons claiming by, through or under them.

10.10. Severability. If any provision of the Plan is held by a court of competent jurisdiction to be invalid or unenforceable, the remaining provisions of the Plan will continue to be fully effective.

IN WITNESS WHEREOF, the undersigned has caused this Preservation of Benefit Plan and Trust to be executed as of this 16 day of February, 2007.

BOARD OF ADMINISTRATION OF THE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM AS TRUSTEES

By: _____

Title: President

Exhibit 15

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM --
PRESERVATION OF BENEFIT PLAN AND TRUST

EMPLOYER: CITY OF SAN DIEGO, CALIFORNIA

Effective January 1, 2007

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM
PRESERVATION OF BENEFIT PLAN AND TRUST

ARTICLE I.

ESTABLISHMENT OF PLAN AND TRUST

1.01. Establishment Of Plan and Trust. The "San Diego City Employees' Retirement System Preservation of Benefit Plan and Trust" ("this Plan") was established effective as of April 18, 2001.

1.02. Purpose. The purpose of this Plan is solely to provide the part of a Participant's Retirement Benefit that would otherwise have been payable by the San Diego City Employees' Retirement System ("SDCERS") from the Employer's qualified plan, except for the limitations of Code Section 415(b). This Plan is intended to be a "qualified governmental excess benefit arrangement" within the meaning of Code Section 415(m)(3) and must be interpreted and construed consistently with that intent. This Plan is deemed a portion of the Employer's qualified plan solely to the extent required under, and within the meaning of, Code Section 415(m)(3) and Article IX of the San Diego City Charter.

This Plan is an "exempt governmental deferred compensation plan" described in Code Section 3121(v)(3). Code Sections 83, 402(b), 457(a) and 457(f)(1) do not apply to this Plan. With respect to Code Section 457(a), the maximum amount that may be deferred under this Plan on behalf of any Participant for the taxable year may exceed both the amount in Code Section 457(b)(2) (as adjusted for cost of living increases) and the percent of the participant's includable compensation referred to in that Code Section. SDCERS will not hold any assets or income under this Plan in trust for the exclusive benefit of participants or their beneficiaries.

ARTICLE II.

DEFINITIONS AND CONSTRUCTIONS

2.01. Definitions. When the initial letter of a word or phrase is capitalized herein, it has the same meaning as defined below:

(a) "**Actuary**" means the actuary selected by the Board from time to time.

(b) "**Administrator**" means SDCERS and includes any person with whom SDCERS contracts to provide services to the Plan.

(c) "**Airport Retirement Plan**" means the San Diego City Employees' Retirement System First Amended Retirement Plan for Airport Authority Employees as administered under the First Amended Agreement to Administer Retirement Plan between San Diego City Employees' Retirement System and San Diego County Regional Airport Authority, or a subsequent retirement plan established by the Airport.

(d) "**Beneficiary**" means an individual receiving joint and survivor benefits from SDCERS.

(e) "**Board**" means the Board of Administration of SDCERS established under Section 144 of the San Diego City Charter.

(f) "**City**" means the City of San Diego, California.

(g) "**Code**" means the Internal Revenue Code of 1986, as amended, as applicable to a governmental plan, or corresponding provisions of any subsequent federal income tax law.

(h) "**Employer**" means the City.

(i) "**Excess Benefit**" means the benefit determined in accordance with Section 4.01 of this Plan.

(j) "**Participant**" means a Retiree or Beneficiary who is entitled to benefits under this Plan.

(k) "**Plan**" means the "San Diego City Employees' Retirement System Preservation of Benefit Plan" established pursuant to Section 24.1601 through 24.1608 of the San Diego Municipal Code.

(l) "**Plan Year**" means the calendar year.

(m) "**Port Retirement Plan**" means the San Diego City Employees' Retirement System Retirement Plan for San Diego Unified Port District Employees as administered under the First Amended Agreement to Administer Retirement Plan between San Diego City Employees' Retirement System and San Diego Unified Port District, or a subsequent retirement plan established by the Port.

(n) "**Retiree**" means a former member of SDCERS who is receiving a Retirement Benefit from SDCERS.

(o) "**Retirement Administrator**" means the SDCERS Retirement Administrator who is appointed by the Board under Board Rule 4.00.

(p) "**Retirement Benefit**" means the amount of retirement income payable to a Retiree of SDCERS, or the benefit payable to a Beneficiary, without regard to any limitations on that retirement income or benefit under Code Section 415(b).

(q) "**Retirement Fund**" means the special fund established by Section 145 of the San Diego City Charter.

(r) "**SDCERS**" means the San Diego City Employees' Retirement System.

(s) "**State**" means the State of California.

(t) "**Trust Fund**" means the trust fund established pursuant to City Ordinance 0-18930, March 19, 2001 and Article VI of this Plan, which fund constitutes a valid trust under the law of the State.

(u) "Trustees" mean the members of the Board.

2.02. Construction.

(a) Words used in this Plan in the masculine gender include the feminine gender where appropriate, and words used in this Plan in the singular or plural include the plural or singular where appropriate.

(b) Whenever any actuarial present value or actuarial equivalency is to be determined under the Plan to establish a benefit, it will be based on reasonable actuarial assumptions approved by the Board in its sole discretion, and will be determined in a uniform manner for all similarly situated Participants.

ARTICLE III.

PARTICIPATION

All Retirees and Beneficiaries of SDCERS are eligible to participate in this Plan if their Retirement Benefits from SDCERS for a Plan Year are or have been since April 18, 2001, limited by Code Section 415(b). The Board determines for each Plan Year which Retirees and Beneficiaries are eligible to participate in the Plan. Participation in the Plan begins each Plan Year once a Retiree or Beneficiary has an Excess Benefit in that Plan Year. Participation in the Plan ends for any portion of a Plan Year in which the Retirement Benefit of a Retiree or Beneficiary is not limited by Code Section 415(b) or when all benefit obligations under the Plan to the Retiree or Beneficiary have been satisfied.

ARTICLE IV.

PAYMENT OF BENEFITS

4.01. Benefit Amount.

(a) A Participant in the Plan will receive a benefit equal to the amount of retirement income that would have been payable to, or with respect to, a Participant by SDCERS that could

not be paid because of the application of the limitations on his retirement income under Code Section 415(b). An Excess Benefit under the Plan will be paid only if and to the extent the Participant is receiving Retirement Benefits from the Retirement Fund.

(b) Where the Administrator pays a blended benefit to a Participant pursuant to Section 0400 of the Port Retirement Plan or Section 0400 of the Airport Retirement Plan, the Excess Benefit payable from this Plan under Section 4.01 will be an amount bearing the same proportion to the total Excess Benefit payable under all plans administered by the Administrator as the Participant's years of service credit with the City bear to the Participant's total years of service credit with all employers sponsoring plans administered by the Administrator.

4.02. Time for Payment; Form of Benefit. The Excess Benefit will be paid at the same time and in the same manner as the Retirement Benefit payable under SDCERS, and the timing of the Excess Benefit must take into account the existence of monthly deductions from the Retirement Benefit. No election is provided at any time to the Participant, directly or indirectly, to defer compensation under this Plan.

ARTICLE V.

CONTRIBUTIONS AND FUNDING

5.01. Funding. The Plan is, and will remain, unfunded and the rights, if any, of any person to any benefits under the Plan are limited to those specified in the Plan. The Plan constitutes a mere unsecured promise by the Employer to make benefit payments in the future.

5.02. Contributions.

(a) The Board will determine the amount necessary to pay the Excess Benefit under the Plan for each Plan Year. The Retirement Administrator will provide an estimate of the Excess Benefit to the Employer on or before February 28 of each year. The required contribution will be the aggregate of the Excess Benefits payable to all Participants for the Plan

Year and an amount determined by the Board to be a necessary and reasonable expense of administering the Plan. The Employer will contribute the amount the Board determines, from time to time, to be necessary to pay the Excess Benefit of the Participant and administrative expenses of the Plan, and these payments will be made before the Employer deposits are credited to the Retirement Fund. The Employer's required contribution will be due no later than July 1 of each year; provided, however, that the Board may establish an earlier due date with respect to contributions necessary to fund the Excess Benefit of any Participant who will exceed the Code Section 415(b) limitations prior to July 1 of that year. Under no circumstances will Employer contributions to fund the Excess Benefits be credited to the Retirement Fund. Any contributions not used to pay the Excess Benefit for a current Plan Year, together with any income accruing to the Trust Fund, will be used to pay the administrative expenses of the Plan for the Plan Year. Any contributions not used to pay the Excess Benefit for the current Plan Year that remain after paying administrative expenses of the Plan for the Plan Year will be used to fund administrative expenses or benefits of Participants in future Plan Years.

(b) If a Participant is employed by more than one employer at the time of the Participant's retirement, the Administrator will determine the appropriate amount of contributions to be paid by each employer to fund the Excess Benefit, and the Excess Benefits will also be paid from the Employer's separate Plans accordingly.

(c) SDCERS will account separately for the amounts the Board determines to be necessary to provide the Excess Benefit under the Plan for each Participant. But, this separate accounting will not be deemed to set aside these amounts for the benefit of a Participant. Benefits under this Plan will be paid from the Trust Fund.

(d) The consultants, independent auditors, attorneys, and actuaries performing services for SDCERS may also perform services for this Plan; but, any fees attributable to services performed with respect to this Plan will be payable solely by the Employer or from the Trust Fund.

ARTICLE VI.

TRUST FUND

6.01. Establishment of Trust Fund. An "Excess Benefit Trust Fund" (the "Trust Fund") was established pursuant to City Ordinance 0-18930, March 19, 2001, separate from the Retirement Fund, to hold contributions of the Employer. Contributions to this Trust Fund will be held separate and apart from the funds comprising the Retirement Fund and will not be commingled with assets of the Retirement Fund, and must be accounted for separately.

6.02. Trust Fund Purpose. The Trust Fund is maintained solely to provide benefits under a qualified governmental excess benefit arrangement within the meaning of Code Section 415(m), and pay administrative expenses of this arrangement.

6.03. Trust Fund Assets. All assets held by the Trust Fund to assist in meeting the Employer's obligations under the Plan, including all amounts of Employer contributions made under the Plan, all property and rights acquired or purchased with these amounts and all income attributable to these amounts, will be held separate and apart from other funds of the Employer and will be used exclusively for the uses and purposes of Participants and general creditors as set forth in this Plan. Participants have no preferred claim on, or any beneficial interest in, any assets of the Trust Fund. Any rights created under the Plan are unsecured contractual rights of Participants against the Employer. Any assets held by the Trust Fund are subject to the claims of the Employer's general creditors under federal and state law in the event of insolvency.

6.04. Grantor Trust. The Trust Fund is intended to be a grantor trust, of which the Employer is the grantor, within the meaning of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code, and will be construed accordingly. This provision will not be construed to create an irrevocable trust of any kind.

6.05. Trust Fund Income. Income accruing to the Trust Fund under the Plan constitutes income derived from the exercise of an essential governmental function upon which the Trust is exempt from tax under Code Section 115, as well as Code Section 415(m)(1).

ARTICLE VII.

ADMINISTRATION

7.01. Administrative Authority. The Board has the exclusive authority to control and manage the operation and administration of the Plan. The Board has the same rights, duties and responsibilities respecting the Plan as it has with respect to the Retirement Fund pursuant to Section 24.1605 of the San Diego Municipal Code. The Administrator has the same duties and authority respecting the Plan as the Administrator has with respect to the Retirement Fund.

(a) The Board has the power and authority (including discretion with respect to the exercise of that power and authority) necessary, advisable, desirable or convenient to enable it:

(1) to establish procedures to administer the Plan not inconsistent with the Plan and the Code, and to amend or rescind these procedures;

(2) to determine, consistent with the Plan, applicable law, rules or regulations, all questions of law or fact that may arise as to eligibility for participation in the Plan and eligibility for distribution of benefits from the Plan, and the status of any person claiming benefits under the Plan;

(3) to make payments from the Trust Fund to Participants pursuant to Article IV of the Plan,

(4) to contract with a third party to perform designated administrative services under this Plan;

(5) to construe and interpret the Plan as to administrative issues and to correct any defect, supply any omission or reconcile any inconsistency in the Plan with respect to same, subject to and consistent with the Code.

(b) Any action by the Board that is not found to be an abuse of discretion will be final, conclusive and binding on all individuals affected thereby. The Board may take any such action in such manner and to such extent as the Board in its sole discretion may deem expedient, and the Board will be the sole and final judge of such expediency.

(c) The Board may delegate any of its authority to the Administrator with respect to the Trust Fund.

(d) The Board will seek appropriate rulings from the Internal Revenue Service with regard to the status of the Plan under the Code.

7.02. Advice. The Board may employ one or more persons to render advice with regard to its responsibilities under the Plan.

7.03. Payment of Benefits. If in doubt concerning the correctness of their action in making a payment of a benefit, the Board may suspend payment until satisfied as to the correctness of the payment or the person to receive the payment.

7.04. Delegation by Administrator. The Administrator will handle the day-to-day operation of the Plan and may delegate certain functions to a third party.

ARTICLE VIII.

PLAN AMENDMENTS

The Board from time to time may amend, suspend, or terminate any or all of the provisions of this Plan as may be necessary to comply with Code Section 415(m) and to maintain the Plan's or the Retirement Fund's qualified status under the Code.

ARTICLE IX.

NONASSIGNABILITY AND EXEMPTION FROM TAXATION AND EXECUTION

The interests of Participants under this Plan are exempt from any state, county, municipal or local tax, and are not subject to execution, garnishment, attachment, or any other process of law whatsoever, and are unassignable and nontransferable, except as otherwise provided by Section 24.1604 of the San Diego Municipal Code.

ARTICLE X.

MISCELLANEOUS

10.01. Federal and State Taxes. The Board, the Employer, and the Administrator, if any, do not guarantee that any particular Federal or State income, payroll, or other tax consequence will occur because of participation in this Plan.

10.02. Investment. The Board may hold a portion of the Plan uninvested as it deems advisable for making distributions under the Plan, or may invest assets of the Plan pending the Excess Benefit payments in short-term investment grade instruments as otherwise permitted by law.

10.03. Conflicts. In resolving any conflict between provisions of the Plan, and in resolving any other uncertainty as to the meaning or intention of any provision of the Plan, the prevailing interpretation will be the one that (i) causes the Plan to constitute a qualified governmental excess benefit arrangement under the provisions of Code Section 415(m) and the

Trust Fund to be exempt from tax under Code Sections 115 and 415(m), (ii) causes the Plan and SDCERS to comply with all applicable requirements of the Code, and (iii) causes the Plan and SDCERS to comply with all applicable State and City laws.

10.04. Limitation on Rights. Neither the establishment or maintenance of the Plan, nor any amendment to the Plan, nor any act or omission under the Plan (or resulting from the operation of the Plan) may be construed:

(a) as conferring upon any Participant or any other person a right or claim against the Board, Trustees, Employer, or Administrator, if any, except to the extent that the right or claim is specifically expressed and provided in the Plan;

(b) as creating any responsibility or liability of the Employer for the validity or effect of the Plan;

(c) as a contract between the Employer and any Participant or other person;

(d) as being consideration for, or an inducement or condition of, employment of any Participant or other person, or as affecting or restricting in any manner or to any extent whatsoever the rights or obligations of the Employer or any Participant or other person to continue or terminate the employment relationship at any time; or

(e) as giving any Participant the right to be retained in the Employer's service or to interfere with the Employer's right to discharge any Participant or other person at any time.

10.05. Erroneous Payments. Any benefit payment that should not have been made, according to the terms of the Plan and the benefits provided hereunder, may be recovered as provided by law.

10.06. Release. Any payment to any Participant will, to the extent thereof, be in full satisfaction of the Participant's claim being paid thereby, and the Board may condition the

payment on the delivery by the Participant of the duly executed receipt and release in a form determined by the Board.

10.07. Liability. The Board, Trustees, or Administrator, if any, will not incur any liability in acting upon any paper or document or electronic transmission believed by the Board, Trustees, or Administrator to be genuine or to be executed or sent by an authorized person.

The Plan will hold harmless and indemnify the Board, the Trustees, and the Administrator, and the officers and employees thereof, from financial loss arising out of any claim, demand, suit or judgment by reason of alleged negligence or other act by that board member, trustee, officer or employee, provided that the board member, trustee, officer or employee at the time of the alleged negligence or act was acting in the discharge of his duties and within the scope of his employment and that the damages did not result from a willful and wrongful act of gross negligence of the board member, trustee, officer or employee, and provided further that the board member, trustee, officer or employee will, within five days of the time he is served with any summons, complaint, process, notice, demand or pleading, deliver the original or a copy thereof to the Administrator's legal advisor.

The Board may obtain insurance to provide coverage for any liabilities that may arise as described by this Section.

10.08. Governing Laws. The San Diego Municipal Code and the laws of the City and the State of California apply in determining the construction and validity of this Plan.

10.09. Necessary Parties to Disputes. The only party necessary to any accounting, litigation or other proceedings relating to the Plan is the Administrator. The settlement or judgment in any case in which the Administrator is duly served will be binding upon all affected

Participants in the Plan, their beneficiaries, estates and upon all persons claiming by, through or under them.

10.10. Severability. If any provision of the Plan is held by a court of competent jurisdiction to be invalid or unenforceable, the remaining provisions of the Plan will continue to be fully effective.

IN WITNESS WHEREOF, the undersigned has caused this Preservation of Benefit Plan and Trust to be executed as of this 16 day of February, 2007.

BOARD OF ADMINISTRATION OF THE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM AS TRUSTEES

By: _____

Title: ~~Interim~~ President

Exhibit 16

August 14, 2007

Mr. David Wescoe
Retirement Administrator
San Diego City Employees' Retirement System
401 West A Street, Suite 400
San Diego, CA 92101

Dear David:

When we appeared before the Board in July, we were asked to update our previous analysis of the experience of the purchase service credit (PSC) program since inception to include all categories of participants (e.g., actives, terminated vested) and those in pay-status (e.g., retirees, beneficiaries and disabilities). This letter presents the results of our update and additional conclusions based on this update.

Exhibit A (attached) provides a summary of our analysis.

Our key findings are as follows:

- Cheiron estimates that the net actuarial deficiency between the additional value of benefits due to the additional service credits and the accumulated amounts paid by all active participants, retirees (including active DROPS), and term vested for such additional credits, as of the June 30, 2006 actuarial valuation, is approximately $146 million.

  As requested, this amount is comprised of the following categories:

a.	Pre-2000	$ 20 million
b.	7/1/2000-6/30/2002	$ 63 million
c.	7/1/2002-8/15/2003	$ 29 million
d.	8/16/2003-10/31/2003	$ 34 million
e.	11/01/2003-6/30/2006	$ 0 million
	Total	$146 million

- Our analysis is consistent with Navigant Consulting's January 2006 estimate of "more than $100 million," which was based on the June 30, 2004 actuarial valuation.

- As we have previously reported to the Board, the current rates being charged today "make the system whole." As a result, we continue to recommend that SDCERS make no change to the current rate structure until we complete our experience study in the summer of 2008. At that time, we will likely recommend changes to the current pricing methodology and review process.

- Approximately $20 million of the $140 million liabilities is not part of SDCERS' unfunded actuarial liabilities (UAL) as of June 30, 2006. This amount represents benefits in excess of IRS limitations (Section 415) and is a direct obligation of the City. Until the on-going work in connection the IRS VCP program is finished, we will not know the final number for this item.

- Amounts reflected in the City's June 30, 2006 UAL are included in the City Annual Required Contribution payment. There would be no impact on SDCERS' financial condition, current or projected, if responsibility for funding this deficiency was transferred from the plan sponsors to others (e.g. current or former members).

- With respect to the UPD and Airport Authority, we presented to the board an analysis in July which showed an additional net PSC liability of $3.7 million attributable to active members as of June 30, 2006.

Finally, our analysis is based June 30, 2006 actual data and reflects accumulative experience gains and losses (people living longer, retiring different than assumed, salary increases, etc.) that could not be anticipated at the time any member actually purchased service.

Please let me know if you have any questions.

Sincerely,
Cheiron

Gene Kalwarski, FSA
Consulting Actuary

Attachment

Exhibit A

CITY of San Diego Purchase Service Credit Analysis

A1. Contracts Effective befoore 7/1/2000 (Pre-Corbett)	GENERAL	SAFETY	TOTAL ACTIVE	RETIREES, TVS, and BENEFICIARIES	GRAND TOTAL
Total Contracts	97	18	115	332	447
Average Age at Purchase	44.6	40.9	44.0	53.9	51.3
Total Years	397	66	463	1,196	1,660
Average Years/contract	4.1	3.7	4.0	3.6	3.7
Contract amount accumulated to June 30, 2006	3,832,614	1,452,109	5,284,723	7,134,269	12,418,992
Additional Liability as of June 30, 2006-Benefits at Purchase Date	5,289,523	1,507,627	6,797,151	26,019,851	32,817,001
Gain/(Loss) **as of June 30, 2006**-Benefits at Purchase Date	$ (1,456,909)	$ (55,518)	$ (1,512,427)	$ (18,885,582)	$ (20,398,009)

A2. Contracts Effective 7/1/2000 - 6/30/2002 (MP2/Old Rates)					
Total Contracts	586	134	720	858	1,578
Average Age at Purchase	44.9	38.4	43.7	53.2	48.9
Total Years	2,469	366	2,834	3,232	6,066
Average Years/contract	4.2	2.7	3.9	3.8	3.8
Contract amount accumulated to June 30, 2006	24,800,778	6,868,596	31,669,375	25,992,860	57,662,235
Additional Liability as of June 30, 2006-Benefits at Purchase Date	37,186,801	6,414,761	43,601,561	76,653,167	120,254,728
Gain/(Loss) **as of June 30, 2006**-Benefits at Purchase Date	$ (12,386,022)	$ 453,836	$ (11,932,186)	$ (50,660,307)	$ (62,592,494)

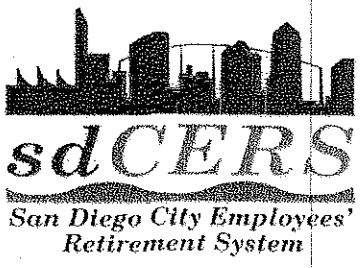
B1. Contracts Effective 7/1/2002 - 8/15/2003 (Board Action/Old Rates)					
Total Contracts	575	194	769	417	1,186
Average Age at Purchase	45.9	39.9	44.4	52.7	47.3
Total Years	2,171	512	2,683	1,446	4,129
Average Years/contract	3.8	2.6	3.5	3.5	3.5
Contract amount accumulated to June 30, 2006	19,712,630	9,347,114	29,059,744	13,797,577	42,857,322
Additional Liability as of June 30, 2006-Benefits at Purchase Date	28,923,615	9,451,816	38,375,431	33,716,183	72,091,615
Gain/(Loss) **as of June 30, 2006**-Benefits at Purchase Date	$ (9,210,985)	$ (104,702)	$ (9,315,687)	$ (19,918,606)	$ (29,234,293)

B2. Contracts Effective 8/16/2003 - 10/31/2003 ("Grandfathered" and "Window" members/Old Rates)					
Total Contracts	1,609	412	2,021	371	2,392
Average Age at Purchase	44.6	40.7	43.8	49.8	44.8
Total Years	5,726	828	6,554	1,287	7,841
Average Years/contract	3.6	2.0	3.2	3.5	3.3
Contract amount accumulated to June 30, 2006	49,363,269	15,510,817	64,874,086	13,297,562	78,171,648
Additional Liability as of June 30, 2006-Benefits at Purchase Date	71,413,136	14,463,793	85,876,929	26,252,431	112,129,360
Gain/(Loss) **as of June 30, 2006**-Benefits at Purchase Date	$ (22,049,867)	$ 1,047,024	$ (21,002,843)	$ (12,954,869)	$ (33,957,712)

C. Contracts Effective 11/1/2003 - Present (New Rates)					
Total Contracts	170	101	271	101	372
Average Age at Purchase	47.2	36.4	43.1	50.4	45.1
Total Years	479	273	752	196	948
Average Years/contract	2.8	2.7	2.8	1.9	2.5
Contract amount accumulated to June 30, 2006	4,966,536	4,063,647	9,030,183	3,068,633	12,098,816
Additional Liability as of June 30, 2006-Benefits at Purchase Date	4,964,886	2,426,237	7,391,123	5,133,245	12,524,368
Gain/(Loss) **as of June 30, 2006**-Benefits at Purchase Date	$ 1,650	$ 1,637,409	$ 1,639,059	$ (2,064,612)	$ (425,553)

D. GRAND Total For All 5 Periods					
Total Contracts	3,037	859	3,896	2,079	5,975
Average Age at Purchase	45.1	39.6	43.9	52.5	46.9
Total Years	11,242	2,045	13,286	7,357	20,643
Average Years/contract	3.7	2.4	3.4	3.5	3.5
Contract amount accumulated to June 30, 2006	102,675,827	37,242,284	139,918,111	63,290,901	203,209,012
Additional Liability as of June 30, 2006-Benefits at Purchase Date	147,777,961	34,264,234	182,042,195	167,774,878	349,817,073
Gain/(Loss) **as of June 30, 2006**-Benefits at Purchase Date	$ (45,102,133)	$ 2,978,049	$ (42,124,084)	$ (104,483,976)	$ (146,608,060)

Exhibit 17



UPDATE ON SDCERS TAX COMPLIANCE IRC §415(b) BENEFIT LIMITS

SDCERS Board of Administration

November 17, 2006

Background Information

- SDCERS is a "qualified governmental plan" under IRC § 401(a).

- To remain qualified, SDCERS must comply with the benefit and compensation limits in IRC § 415 (b) and (c).

- Benefit limit is a cap on the amount of benefits the plan may pay to a retiree or beneficiary in a calendar year.

Background Information cont.

•To determine whether a payee will exceed the benefit limit, SDCERS must determine each payee's (1) individual benefit limit and (2) aggregate benefit to be tested.

•Adjustments to the aggregate benefit and the benefit limit are based on a number of factors:

- •combined benefit amount (includes 13th check, Corbett, DROP)
- •statutory benefit limit in effect at retirement
- •age at retirement
- •years of service
- •type of service (IRS Safety Qualified)
- •post-tax contributions
- •post-tax service purchases

Background Information cont.

- Cheiron built the calculator that SDCERS staff will use to determine individual:
  - annual limits
  - aggregate benefits
  - projected failures

- Each payee's annual limit must be recalculated annually.

Prospective Screening and Compliance

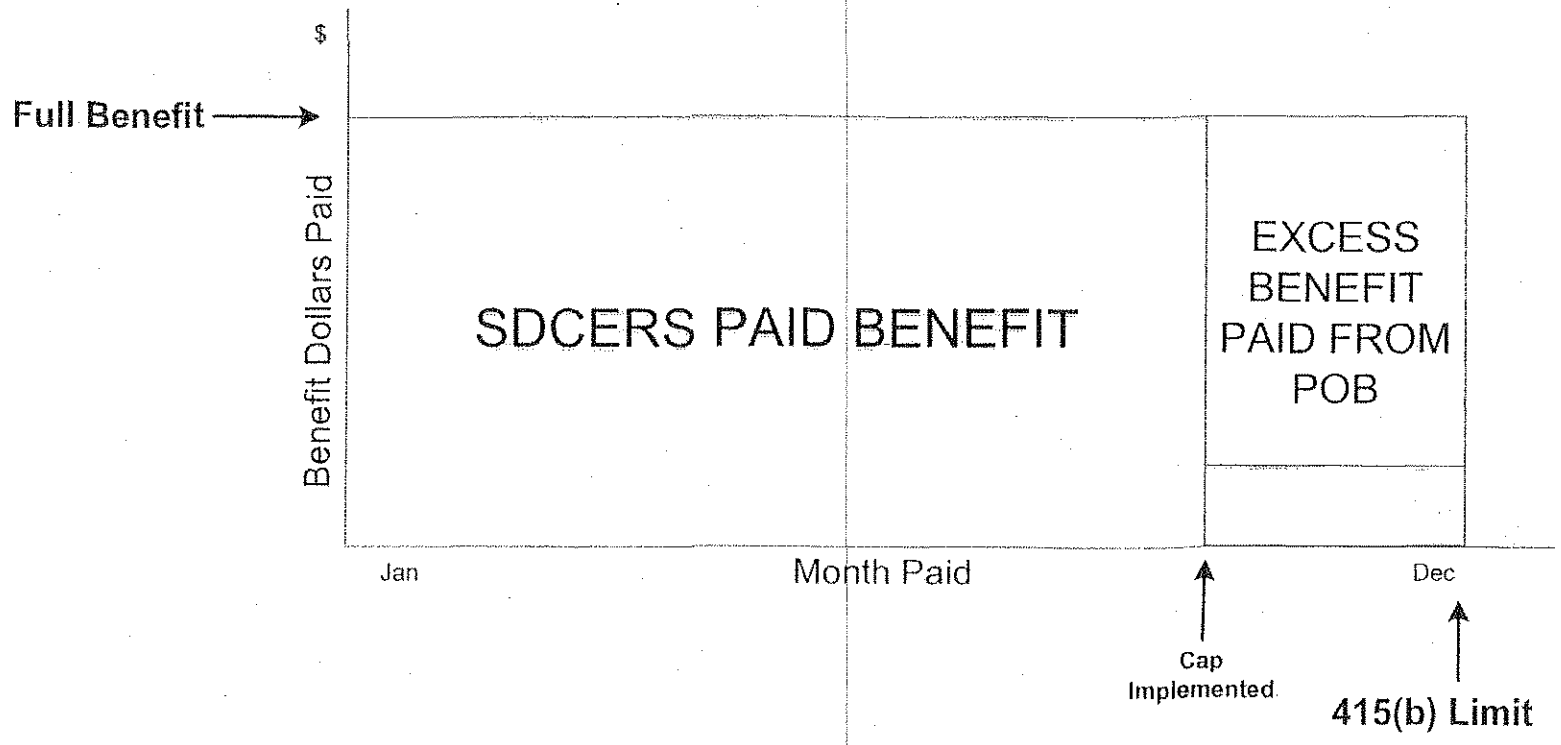
•Beginning January 1, 2007, SDCERS will screen all members when they apply for retirement, by calculating each member's exact 415(b) limit and aggregate benefit using Cheiron's calculator.

•**All members on January 2007 agenda will have been pre-screened.**

•SDCERS will implement a benefit cap for each payee expected to exceed his benefit limit using a "modified cliff" approach. This allows SDCERS to pay out complete DROP payments, and ensures enough retirement benefit dollars to cover any deductions.

•The excess benefits will be deducted entirely from the member's pension.

Modified Cliff



Prospective Screening and Compliance cont.

- In addition, Cheiron will:
  - Screen the entire population of payees quarterly, and
  - Update the 415(b) calculator every year to reflect current IRS limits.

Preservation of Benefit Plans Background

•SDMC 24.1601 et seq. authorizes a Qualified Excess Benefit Arrangement under 415(m) – called "Preservation of Benefits Plan." (Similar provisions in Port and Airport Plans)

•Separate "Preservation of Benefit Plan and Trust" will be established for each Plan Sponsor.

•The POB plans allow payment of the part of a retiree or beneficiary's benefit that is due under the defined benefit plans, but exceeds the benefit limit.

•SDCERS is applying for a Private Letter Ruling approving the POB Plans.

•The SDCERS Board will have the exclusive authority to administer the POB plans.

Employer Funding of the Preservation of Benefit Plans

•Each January, Staff will prepare for Board approval an estimate of the annual contribution for each Plan Sponsor, which will include:

- projected excess benefits that will be due to the existing payees for that calendar year,
- projected excess benefits for the anticipated retirements in that year, and
- necessary and reasonable expense of administering each Plan Sponsor's POB plan.

•Any contributions not used to pay benefits or administrative expenses in a given year will be used to pay benefits or expenses in a later year.

Retrospective Testing

- January 2007 - SDCERS will give Cheiron a schedule of all members receiving benefits as of 12/31/2006.

- Cheiron will identify and report all "failures" (benefits paid in excess of 415(b).

- SDCERS will invoice the Plan Sponsors for amounts paid above 415(b) limit before 2007.